FEDERAL RESERVE BANK
OF DALLAS

ROBERT D. McTEER, JR.
PRESIDENT
AND CHIEF EXECUTIVE OFFICER

DALLAS, TEXAS
75265-5906

January 4, 1995

Notice 95-01

TO: The Chief Executive Officer of each member bank and others concerned in the Eleventh Federal Reserve District

SUBJECT

Final Amendments to the Risk-based Capital Guidelines

DETAILS

The Board of Governors of the Federal Reserve System has issued amendments to the risk-based capital guidelines for state member banks and bank holding companies to recognize the risk-reducing benefits of netting arrangements. Under the amendments, institutions will be permitted to net, for risk-based capital purposes, the mark-to-market of interest and exchange rate contracts subject to qualifying bilateral netting contracts.

The amendments will allow state member banks and holding companies to net positive and negative mark-to-market values of rate contracts in determining the current exposure portion of the credit equivalent amount of such contracts to be included in risk-weighted assets. The amendments became effective December 31, 1994.

ATTACHMENT

A copy of the Board's notice as it appears on pages 62987-95, Vol. 59, No. 234, of the Federal Register dated December 7, 1994, is attached.

MORE INFORMATION

For more information, please contact Dorsey Davis at (214) 922-6051. For additional copies of this Bank's notice, please contact the Public Affairs Department at (214) 922-5254.

Sincerely yours,

Robert D. McTeer, Jr.

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225

[Regulations H and Y; Docket No. R–0837]

Capital; Capital Adequacy Guidelines

AGENCY: Board of Governors of the Federal Reserve System.
ACTION: Final rule.

SUMMARY: The Board of Governors of the Federal Reserve System (Board) is amending its risk-based capital guidelines to recognize the risk-reducing benefits of qualifying bilateral netting contracts. This final rule implements a recent revision to the Basle Accord permitting the recognition of such netting arrangements. The effect of the final rule is that state member banks and bank holding companies (banking organizations, institutions) may net positive and negative mark-to-market values of interest and exchange rate contracts in determining the current exposure portion of the credit equivalent amount of such contracts to be included in risk-weighted assets.

EFFECTIVE DATE: December 31, 1994.

FOR FURTHER INFORMATION CONTACT: Roger Cole, Deputy Associate Director (202/452–2618), Norah Barger, Manager (202/452–2402), Robert Motyka, Supervisory Financial Analyst (202/452–3621), Barbara Bouchard, Supervisory Financial Analyst (202/452–3072), Division of Banking Supervision and Regulation; or Stephanie Martin, Senior Attorney (202/452–3198), Legal Division. For the hearing impaired only, Telecommunications Device for the Deaf, Dorothea Thompson (202/452–3544), 20th and C Streets, N.W., Washington, D.C. 20551.

SUPPLEMENTARY INFORMATION:

Background

The Basle Accord [1] established a risk-based capital framework which was implemented for state member banks and bank holding companies by the Board in 1989. Under this framework, off-balance-sheet interest rate and exchange rate contracts (rate contracts) are incorporated into risk weighted assets by converting each contract into a credit equivalent amount. This amount is then assigned to the appropriate credit risk category according to the identity of the obligor or counterparty or, if relevant, the guarantor or the nature of the collateral. The credit equivalent amount of an interest or exchange rate contract can be assigned to a maximum credit risk category of 50 percent.

The credit equivalent amount of a rate contract is determined by adding together the current replacement cost (current exposure) and an estimate of the possible increase in future replacement cost in view of the volatility of the current exposure over the remaining life of the contract (potential future exposure, also referred to as the add-on).[2]

For risk-based capital purposes, a rate contract with a positive mark-to-market value has a current exposure equal to that market value. If the mark-to-market value of a rate contract is zero or negative, then there is no replacement cost associated with the contract and the current exposure is zero. The original Basle Accord and the Board's guidelines provided that current exposure would be determined individually for each rate contract entered into by a banking organization; institutions generally were not permitted to offset, that is, net, positive and negative market values of multiple rate contracts with a single counterparty to determine one current credit exposure relative to that counterparty.[3]

In April 1993 the Basle Supervisors' Committee proposed a revision to the Basle Accord, endorsed by the G–10 Governors in July 1994, that permits institutions to net positive and negative market values of rate contracts subject to a qualifying, legally enforceable, bilateral netting arrangement. Under the revision, institutions with a qualifying netting arrangement may calculate a single net current exposure for purposes of determining the credit equivalent amount for the included contracts.[4] If the net market value of the contracts included in such a netting arrangement is positive, then that market value equals the current exposure for the netting contract. If the net market value is zero or negative, then the current exposure is zero.

The Board's Proposal

On May 20, 1994, the Board and the Office of the Comptroller of the Currency (OCC) issued a joint proposal to amend their respective risk-based capital standards (59 FR 26456) in accordance with the Basle Supervisors' Committee's April 1993 proposal.[5] The joint proposal provided that for capital purposes institutions regulated by the Board and the OCC could net the positive and negative market values of interest and exchange rate contracts subject to a qualifying, legally enforceable, bilateral netting contract to calculate one current exposure for that netting contract (sometimes referred to as the master netting contract).

The proposal provided that the net current exposure would be determined by adding together all positive and negative market values of individual contracts subject to the netting contract. The net current exposure would equal the sum of the market values if that sum is a positive value, or zero if the sum of

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[1] The Basle Accord is a risk-based framework that was proposed by the Basle Committee on Banking Supervision (Basle Supervisors' Committee) and endorsed by the central bank governors of the Group of Ten (G–10) countries in July 1988. The Basle Supervisors' Committee is comprised of representatives of the central banks and supervisory authorities from the G–10 countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, the United Kingdom, and the United States) and Luxembourg.

[2] This method of determining credit equivalent amounts for rate contracts is identified in the Basle Accord as the current exposure method, which is used by most international banks.

[3] It was noted in the Accord that the legal enforceability of certain netting arrangements was unclear in some jurisdictions. The legal status of netting by novation, however, was determined to be settled and this limited type of netting was recognized. Netting by novation is accomplished under a written bilateral contract providing that any obligation to deliver a given currency on a given date is automatically amalgamated with all other obligations for the same currency and value date. The previously existing contracts are extinguished and a new contract for the single net amount, in effect, legally replaces the amalgamated gross obligations.

[4] The revision to the Accord notes that national supervisors must be satisfied about the legal enforceability of a netting arrangement under the laws of each jurisdiction relevant to the arrangement. The Accord also states that, if any supervisor is dissatisfied about enforceability under its own laws, the netting arrangement does not satisfy this condition and neither counterparty may obtain supervisory benefit.

[5] The Office of Thrift Supervision (OTS) issued a similar netting proposal on June 14, 1994 and the Federal Deposit Insurance Corporation (FDIC) issued its netting proposal on July 25, 1994.

the market values is zero or a negative value. The proposals did not alter the calculation method for potential future exposure.[6]

Under the proposal, institutions would be able to net for risk-based capital purposes only with a written bilateral netting contract that creates a single legal obligation covering all included individual rate contracts and does not contain a walkaway clause.[7] The proposal required an institution to obtain a written and reasoned legal opinion(s) stating that under the master netting contract the institution would have a claim to receive, or an obligation to pay, only the net amount of the sum of the positive and negative market values of included individual contracts if a counterparty failed to perform due to default, insolvency, bankruptcy, liquidation, or similar circumstances.

The proposal indicated that the legal opinion must normally cover: (i) The law of the jurisdiction in which the counterparty is chartered, or the equivalent location in the case of noncorporate entities, and if a branch of the counterparty is involved, the law of the jurisdiction in which the branch is located; (ii) the law that governs the individual contracts covered by the netting contract; and (iii) the law that governs the netting contract.

The proposal provided that an institution must maintain in its files documentation adequate to support the bilateral netting contract. Documentation would typically include a copy of the bilateral netting contract, legal opinions and any related translations. In addition, the proposal required an institution to establish and maintain procedures to ensure that the legal characteristics of netting contracts would be kept under review.

Under the proposal, the Federal Reserve could disqualify any or all contracts from netting treatment for risk-based capital purposes if the requirements of the proposal were not satisfied. In the event of disqualification, the affected contracts would be treated as though they were not subject to the master netting contract. The proposal indicated that outstanding netting by novation arrangements would not be grandfathered, that is, such arrangements would have to meet all of the proposed requirements for qualifying bilateral netting contracts.

The proposal requested general comments as well as specific comments on the nature of collateral arrangements and the extent to which collateral might be recognized in conjunction with bilateral netting contracts.

Comments Received

The Board received nineteen public comments on the proposed amendment. Eleven comments were from banking organizations and five were from industry trade associations and organizations. In addition, there were three comments from law firms. All commenters supported the expanded recognition of bilateral netting contracts for risk-based capital purposes. Several commenters encouraged recognition of such contracts as quickly as possible. Many of the commenters concurred with one of the principal underlying tenets of the proposal, that is, that legally enforceable bilateral netting contracts can provide an efficient and desirable means for institutions to reduce or control credit exposure. A few commenters noted that, in their view, the recognition of bilateral netting contracts would create an incentive for market participants to use such arrangements and would encourage lawmakers to clarify the legal status of netting arrangements in their jurisdictions. One commenter noted that the expanded recognition of bilateral netting contracts would help keep U.S. banking organizations competitive in global derivatives markets.

While generally expressing their endorsement for the expanded recognition of bilateral netting contracts, nearly all commenters offered suggestions or requested clarification regarding details of the proposals. In particular, the commenters raised issues concerning specifics of the required legal opinions, the treatment of collateral, and the grandfathering of walkaway clauses and novation agreements.

Legal Opinions

Almost all commenters addressed the proposed requirement that institutions obtain legal opinions concluding that their bilateral netting contracts would be enforceable in all relevant jurisdictions. Commenters did not object to the general requirement that they secure legal opinions, rather they raised a number of questions about the form and substance of an acceptable opinion.

Form. Several commenters requested clarification as to the specific form of the legal opinion. Commenters wanted to know if a memorandum of law would satisfy the requirement or if a legal *opinion* would be required. They questioned whether a memorandum or opinion could be addressed to, or obtained by, an industry group, and whether a generic opinion or memorandum relating to a standardized netting contract would satisfy the legal opinion requirement.

Several commenters suggested that an opinion secured on behalf of the banking industry by an organization should be sufficient so long as the individual institution's counsel concurs with the opinion and concludes that the opinion applies directly to the institution's specific netting contract and to the individual contracts subject to it. A few commenters requested confirmation that legal opinions would not have to follow a predetermined format.

Scope. Several commenters identified two possible interpretations of the proposed language with regard to the scope of the legal opinions. They asked for clarification as to whether the opinions would be required to discuss only whether all relevant jurisdictions would recognize the contractual choice of law, or whether they must also discuss the enforceability of netting in bankruptcy or other instances of default. One commenter suggested deleting the requirement for a choice of law analysis.

A number of commenters objected to the proposed requirement that the legal opinion for a multibranch netting contract (that is, a netting contract between multinational banks that includes contracts with branches of the parties located in various jurisdictions) address the enforceability of netting under the law of the jurisdiction where each branch is located. These commenters stated that it should be sufficient for the legal opinion to conclude that netting would be enforced in the jurisdiction of the counterparty's home office if the master netting contract provides that all transactions are considered obligations of the home office and the branch jurisdictions recognize that provision.

Severability. Several commenters expressed concern about the proposed treatment for netting contracts that include contracts with branches in jurisdictions where the enforceability of netting is unclear. In such circumstances, commenters asserted, unenforceability or uncertainty in one

[6] Potential future exposure is estimated by multiplying the effective notional amount of a contract by a credit conversion factor which is based on the type of contract and the remaining maturity of the contract. Under the Board/OCC proposal, a potential future exposure amount would be calculated for each individual contract subject to the netting contract. The individual potential future exposures would then be added together to arrive at one total add-on amount.

[7] A walkaway clause is a provision in a netting contract that permits a non-defaulting counterparty to make lower payments than it would make otherwise under the contract, or no payment at all, to a defaulter or to the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the contract.

jurisdiction should not invalidate the entire netting contract for risk-based capital netting treatment. These commenters contended that contracts with branches of a counterparty in jurisdictions that recognize netting arrangements should be netted and contracts with branches in jurisdictions where the enforceability of netting is not supported by legal opinions should, for risk-based capital purposes, be severed, or removed from the master netting contract and treated as though they were not subject to that contract. These commenters noted that this treatment should only be available to the extent it is supported by legal opinion.

Conclusions. The proposal required a legal opinion to conclude that "relevant court and administrative authorities would find" the netting to be effective. Many commenters that discussed this aspect of the proposal expressed concern that this standard was too high. They suggested, instead, that the opinions be required to conclude that netting "should" be effective.

A few commenters requested clarification regarding the proposed requirement that the netting contract must create a single legal obligation.

Collateral

Twelve commenters addressed the proposal's specific request for comment on the nature of collateral and the extent to which collateral might be recognized in conjunction with bilateral netting contracts. All of these commenters believed collateral should be recognized as a means of reducing credit exposure. A few commenters noted that collateral arrangements are increasingly being used with derivative transactions.

Several commenters stated that for netting contracts that call for the use of collateral, the amount of required collateral is determined from the net mark-to-market value of the master netting contract. A few commenters added that mark-to-market collateral often is used in conjunction with a collateral "add-on" based on such things as the notional amount of the underlying contracts, the maturities of the contracts, the credit quality of the counterparty, and volatility levels.

A number of commenters offered their opinions as to how collateral should be recognized for risk-based capital purposes. Some suggested that the existing method of recognizing collateral for purposes of assigning credit equivalent amounts to risk categories is applicable to derivative transactions as well. Other commenters expressed the view that collateral should be recognized when assigning risk weights to the extent it is legally available to cover the total credit exposure for the bilateral netting contract in the event of default and that this availability should be addressed in the legal opinions.

Several other commenters suggested separating the net current exposure and potential future exposure of bilateral netting contracts for determining collateral coverage and appropriate risk weights. One commenter favored recognizing collateral for capital purposes by allowing an institution to offset net current exposure by the amount of the collateral to further reduce the credit equivalent amount.

Two commenters requested clarification that contracts subject to qualifying netting contracts could be eligible for a zero percent risk weight if the transaction is properly collateralized in accordance with the Board's collateralized transactions rule.[8]

Walkaway Clauses

Several commenters addressed the proposed prohibition against walkaway clauses in contracts qualifying for netting for risk-based capital purposes. While most of these commenters agreed that, ultimately, walkaway clauses should be eliminated from master netting contracts, they favored a phase-out period, during which outstanding bilateral netting contracts containing walkaway clauses could qualify for capital netting treatment. Several commenters contended that if a defaulter is a net debtor under the contract, the existence of a walkaway clause would not affect the amount owed to the non-defaulting creditor.

Novation

A few commenters expressed concern that the proposal did not grandfather outstanding novation agreements. These commenters suggested a phase-in period during which novation agreements would not be required to be supported by legal opinions.

Other Issues

One commenter requested greater detail on the nature and extent of examination review procedures. Two commenters stated that in some situations obtaining translations might be burdensome. Another commenter suggested assurance that the Federal Reserve would not disqualify netting contracts in an unreasonable manner.

Approximately one-half of the commenters expressed concern that the proposal specifically was limited to interest rate and exchange rate contracts. All of these opposed limiting the range of products that could be included under qualifying netting contracts. In this regard, one commenter noted that where there is sufficient legal support confirming the enforceability of cross-product netting, such netting should be recognized for capital purposes.

A number of commenters used the proposal as an opportunity to discuss the manner in which the add-on for potential future exposure is calculated. They suggested netting contracts should be recognized not only as a way to reduce the current exposure to a counterparty, but also the effects of such netting contracts should be taken into account to reduce the amount of capital organizations must hold against the potential future exposure to the counterparty.

Final Rule

After considering the public comments received and further deliberating the issues involved, the Board is adopting a final rule recognizing, for capital purposes, qualifying bilateral netting contracts. This final rule is substantially the same as proposed.

Legal Opinions

Form. The final rule requires that institutions obtain a written and reasoned legal opinion(s) concluding that the netting contract is enforceable in all relevant jurisdictions. This requirement is aimed at ensuring there is a substantial legal basis supporting the legal enforceability of a netting contract before reducing a banking organization's capital requirement based on that netting contract. A legal opinion, as generally recognized by the legal community in the United States, can provide such a legal basis. A memorandum of law may be an acceptable alternative as long as it addresses all of the relevant issues in a credible manner.

As discussed in the proposal, the legal opinions may be prepared by either an outside law firm or an institution's in-house counsel. The salient requirements for an acceptable legal opinion are that it: (i) Addresses all relevant jurisdictions; and (ii) concludes with a high degree of certainty that in the event of a legal challenge the banking

[8] In December 1992 the Board issued an amendment to its risk-based capital guidelines permitting certain collateralized transactions to qualify for a zero percent risk weight (57 FR 62180, December 30, 1992). In order to qualify for a zero percent risk weight, an institution must maintain a positive margin of qualifying collateral at all times. Thus, the collateral arrangement should provide for immediate liquidation of the claim in the event that a positive margin of collateral is not maintained. The OCC has issued a similar proposal (58 FR 43822, August 18, 1993).

organization's claim or obligation would be determined by the relevant court or administrative authority to be the net sum of the positive and negative mark-to-market values of all individual contracts subject to the bilateral netting contract. The subject matter and complexity of required legal opinions will vary.

To some extent, institutions may use general, standardized opinions to help support the legal enforceability of their bilateral netting contracts. For example, a banking organization may have obtained a memorandum of law addressing the enforceability of netting provisions in a particular foreign jurisdiction. This opinion may be used as the basis for recognizing netting generally in that jurisdiction. However, with regard to an individual master netting contract, the general opinion would need to be supplemented by an opinion that addresses issues such as the enforceability of the underlying contracts, choice of law, and severability.

For example, the Board does not believe that a generic opinion prepared for a trade association with respect to the effectiveness of netting under the standard form agreement issued by the trade association, by itself, is adequate to support a netting contract. Banking organizations using such general opinions would need to supplement them with a review of the terms of the specific netting contract that the institution is executing.

Scope. With regard to the scope of the legal opinions, that is, what areas of analysis must be covered, the Board is of the opinion that legal opinions must address the validity and enforceability of the entire netting contract. The opinion must conclude that under the applicable state or other jurisdictional law the netting contract is a legal, valid, and binding contract, enforceable in accordance with its terms, even in the event of insolvency, bankruptcy, or similar proceedings. Opinions provided on the law of jurisdictions outside of the U.S. should include a discussion and conclusion that netting provisions do not violate the public policy or the law of that jurisdiction.

The Board has further determined that one of the most critical aspects of a qualifying netting contract is the contract's enforceability in any jurisdiction whose law would likely be applied in an enforcement action, as well as the jurisdiction where the counterparty's assets reside. In this regard, and in light of the policy in some countries to liquidate branches of foreign banking organizations independent of the head office, the Board is retaining its proposed requirement that legal opinions address the netting contract's enforceability under: (i) The law of the jurisdiction in which the counterparty is chartered, or the equivalent location in the case of noncorporate entities, and if a branch of the counterparty is involved, the law of the jurisdiction in which the branch is located; (ii) the law that governs the individual contracts subject to the bilateral netting contract; and (iii) the law that governs the netting contract.

Severability. The Board recognizes that for some multibranch netting contracts an organization may not be able to obtain a legal opinion(s) concluding that netting would be enforceable in every jurisdiction where branches covered under the master netting contract are located. The Board concurs with commenters that in such situations it may be inefficient to require institutions to renegotiate netting contracts to ensure they cover only those jurisdictions where netting is clearly enforceable. The Board has determined that, in certain circumstances for capital purposes, banking institutions may use master bilateral netting contracts that include contracts with branches across all jurisdictions. Banking institutions should calculate their net current exposure for the contracts in those jurisdictions where netting clearly is enforceable as supported by legal opinion(s). The remaining contracts subject to the netting contract should be severed from the netting contract and treated as though they were not subject to the netting contract for capital and credit purposes. This approach of essentially dividing contracts subject to the netting contact into two categories—those that clearly may be netted and those that may not—is acceptable provided that the banking organization's legal opinions conclude that the contracts that do not qualify for netting treatment are legally severable from the master netting contract and that such severance will not undermine the enforceability of the netting contract for the remaining qualifying contracts.

Conclusions. The Board has retained the proposed language that legal opinions must represent that netting would be enforceable in all relevant jurisdictions. In response to commenters' assertions that the standard for this type of legal opinion is too high, the Board notes that use of the word "would" in the capital rules does not necessarily mean that the legal opinions must also use the word "would" or that enforceability must be determined to be an absolute certainty. The intent, rather, is for banking organizations to secure a legal opinion concluding that there is a high degree of certainty that the netting contract will survive a legal challenge in any applicable jurisdiction. The degree of certainty should be apparent from the reasoning set out in the opinion.

The Board notes that the requirement for legal opinions to conclude that netting contracts must create a single legal obligation applies only to those individual contracts that are covered by, and included under, the netting contract for capital purposes. As discussed above, a netting contract may include individual contracts that do not qualify for netting treatment, provided that these individual contracts are legally severable from the contracts to be netted for capital purposes.

Institutions generally must include all contracts covered by a qualifying netting contract in calculating the current exposure of that netting contract. In the event a netting contract covers transactions that are normally excluded from the risk-based ratio calculation—for example, exchange rate contracts with an original maturity of fourteen calendar days or less or instruments traded on exchanges that require daily payment of variation margin—an institution may choose to either include or exclude all mark-to-market values of such contracts when determining net current exposure, but this choice must be followed consistently.

Collateral

The final rule permits, subject to certain conditions, institutions to take into account qualifying collateral when assigning the credit equivalent amount of a netting contract to the appropriate risk weight category in accordance with the procedures and requirements currently set forth in the Board's risk-based capital guidelines. The Board has added language to the final rule clarifying that collateral must be legally available to cover the credit exposure of the netting contract in the event of default. For example, the collateral may not be pledged solely against one individual contract subject to the master netting contract. The legal availability of the collateral must be addressed in the legal opinions.

Walkaway Clauses

The Board has considered the suggestion made by some commenters of a phase-out period for outstanding contracts with walkaway clauses. The Board continues to believe that walkaway clauses do not reduce credit risk. Accordingly, the final rule retains the provision that bilateral netting contracts with walkaway clauses are no

eligible for netting treatment for risk-based capital purposes and does not provide for a phase-out period.

Novation

The proposal required all netting contracts, including netting by novation agreements, to be supported by written legal opinions. The Board does not agree with commenters that a grandfathering period for outstanding novation agreements is needed. Rather, the Board continues to believe that all netting contracts must be held to the same standards in order to promote certainty as to the legal enforceability of the contracts and to decrease the risks faced by counterparties in the event of default. Under the final rule, a netting by novation agreement must meet the requirements for a qualifying bilateral netting contract.

Other Issues

The Board has considered all of the other issues raised by commenters. With regard to documentation, the Board reiterates that, as with all provisions of risk-based capital, a banking organization must maintain in its files appropriate documentation to support any particular capital treatment including netting of rate contracts. Appropriate documentation typically would include a copy of the bilateral netting contract, supporting legal opinions, and any related translations. The documentation should be available to examiners for their review.

The Board recognizes commenters' concerns that the proposed rule was limited specifically to interest and exchange rate contracts. The Board notes that both the Basle Accord and the Board's risk-based capital guidelines currently do not address derivatives contracts other than rate contracts. This final rule does not attempt to go beyond the scope of the existing risk-based capital framework and applies only to netting contracts encompassing interest rate and foreign exchange rate contracts. The Board, however, notes that the Basle Supervisors' Committee issued a proposal for public comment in July 1994 to amend the Basle Accord that explicitly would set forth the risk-based capital treatment for other types of derivative transactions, such as commodity, precious metal, and equity contracts. In this regard, the Board issued a similar proposal, based on the Basle Supervisors' Committee proposal, to amend its risk-based capital guidelines (59 FR 43508, August 24, 1994).

Until the Basle Accord has been revised and the Board's risk-based capital rules have been amended to encompass commodity, precious metal, and equity derivative contracts, the Board, rather than automatically disqualifying from capital netting treatment an entire netting contract that includes non-rate-related transactions, will permit institutions to apply the following treatment. In determining the current exposure of otherwise qualifying netting contracts that include non-rate-related contracts, institutions will be permitted to net the positive and negative mark-to-market values of the included interest and exchange rate contracts, while severing the non-rate-related contracts and treating them for risk-based capital purposes as individual contracts that are not subject to the master netting contract. (This treatment is similar to the treatment applied to a netting contract that includes contracts in jurisdictions where the enforceability of netting is not supported by legal opinion. With non-rate-related contracts, however, legal opinions on severability are not required.)

The Board notes that the regulatory language with regard to the calculation of potential future exposure remains essentially the same as that proposed. The Board has clarified an underlying premise of the current exposure method for calculating credit exposure as set forth in the Basle Accord, that is, the add-on for potential future exposure must be calculated based on the effective, rather than the apparent, notional principal amount and the notional amount an institution uses will be subject to examiner review.[9]

Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act, the Board hereby certifies that this final rule will not have a significant impact on a substantial number of small business entities. Accordingly, a regulatory flexibility analysis is not required.

Paperwork Reduction Act and Regulatory Burden

The Board has determined that this final rule will not increase the regulatory paperwork burden of banking organizations pursuant to the provisions of the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*).

Section 302 of the Riegle Community Development and Regulatory Improvement Act of 1994 (Pub. L. 103-325, 108 Stat. 2160) provides that the federal banking agencies must consider the administrative burdens and benefits of any new regulation that imposes additional requirements on insured depository institutions. Section 302 also requires such a rule to take effect on the first day of the calendar quarter following final publication of the rule, unless the agency, for good cause, determines an earlier effective date is appropriate.

The new capital rule imposes certain requirements on depository institutions that wish to net the current exposures of their rate contracts for purposes of calculating their risk-based capital requirements. For these institutions, any burden of complying with the requirements of netting under a legally enforceable netting contract and obtaining the necessary legal opinions should be outweighed by the benefits associated with a lower capital requirement. The new rule will not affect institutions that do not wish to net for capital purposes. For these reasons, the Board has determined that an effective date of December 31, 1994 is appropriate, in order to allow banking organizations to take advantage of netting in their year-end statements, if they so desire. For these same reasons, in accordance with 5 U.S.C. 553(d)(3) the Board finds there is good cause not to follow the 30-day notice requirements of 5 U.S.C. 553(d) and to make the rule effective on December 31, 1994.

List of Subjects

12 CFR Part 208

Accounting, Agriculture, Banks, banking, Branches, Capital adequacy, Confidential business information, Crime, Currency, Federal Reserve System, Mortgages, Reporting and recordkeeping requirements, Securities, State member banks.

12 CFR Part 225

Administrative practice and procedure, Banks, banking, Capital adequacy, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities.

Authority and Issuance

For the reasons set out in the preamble, parts 208 and 225 of chapter II of title 12 of the Code of Federal Regulations are amended as set forth below.

[9] The notional amount is, generally, a stated reference amount of money used to calculate payment streams between the counterparties. In the event that the effect of the notional amount is leveraged or enhanced by the structure of the transaction, institutions must use the actual, or effective, notional amount when determining potential future exposure.

PART 208—MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM (REGULATION H)

1. The authority citation for part 208 is revised to read as follows:

Authority: 12 U.S.C. 36, 248(a) and 248(c), 321–338a, 371d, 461, 481–486, 601, 611, 1814, 1823(j), 1828(o), 1831o, 1831p-1, 3105, 3310, 3331–3351 and 3906–3909; 15 U.S.C. 78b, 78l(b), 78l(g), 78l(i), 78o-4(c)(5), 78q, 78q-1 and 78w; 31 U.S.C. 5318.

2. Appendix A to part 208 is amended by revising:

a. Section III.E.2.;

b. Section III.E.3;

c. Section III.E.5.;

d. The last heading and two subsequent paragraphs of Attachment IV; and

e. Attachment V.

The revisions read as follows:

Appendix A to Part 208—Capital Adequacy Guidelines for State Member Banks: Risk-Based Measure

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III. * * *

E. * * *

12. *Calculation of credit equivalent amounts. a.* The credit equivalent amount of an off-balance-sheet rate contract that is not subject to a qualifying bilateral netting contract in accordance with section III.E.5. of this appendix A is equal to the sum of (i) the current exposure (sometimes referred to as the replacement cost) of the contract; and (ii) an estimate of the potential future credit exposure over the remaining life of the contract.

b. The current exposure is determined by the mark-to-market value of the contract. If the mark-to-market value is positive, then the current exposure is that mark-to-market value. If the mark-to-market value is zero or negative, then the current exposure is zero. Mark-to-market values are measured in dollars, regardless of the currency or currencies specified in the contract, and should reflect changes in the relevant rates, as well as counterparty credit quality.

c. The potential future credit exposure of a contract, including a contract with a negative mark-to-market value, is estimated by multiplying the notional principal amount of the contract by a credit conversion factor. Banks should, subject to examiner review, use the effective rather than the apparent or stated notional amount in this calculation. The conversion factors are:

Remaining maturity	Interest rate contracts (percent)	Exchange rate contracts (percent)
One year or less	0	1.0
Over one year	0.5	5.0

d. Examples of the calculation of credit equivalent amounts for these instruments are contained in Attachment V of this appendix A.

e. Because exchange rate contracts involve an exchange of principal upon maturity, and exchange rates are generally more volatile than interest rates, higher conversion factors have been established for foreign exchange rate contracts than for interest rate contracts.

f. No potential future credit exposure is calculated for single currency interest rate swaps in which payments are made based upon two floating rate indices, so-called floating/floating or basis swaps; the credit exposure on these contracts is evaluated solely on the basis of their mark-to-market values.

3. *Risk weights.* Once the credit equivalent amount for an interest rate or exchange rate contract has been determined, that amount is assigned to the risk weight category appropriate to the counterparty, or, if relevant, to the guarantor or the nature of any collateral.[49] However, the maximum weight that will be applied to the credit equivalent amount of such instruments is 50 percent.

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5. *Netting.* a. For purposes of this appendix A, netting refers to the offsetting of positive and negative mark-to-market values in the determination of a current exposure to be used in the calculation of a credit equivalent amount. Any legally enforceable form of bilateral netting (that is, netting with a single counterparty) of rate contracts is recognized for purposes of calculating the credit equivalent amount provided that:

i. The netting is accomplished under a written netting contract that creates a single legal obligation, covering all included individual contracts, with the effect that the bank would have a claim to receive, or obligation to pay, only the net amount of the sum of the positive and negative mark-to-market values on included individual contracts in the event that a counterparty, or a counterparty to whom the contract has been validly assigned, fails to perform due to any of the following events: Default, insolvency, liquidation, or similar circumstances.

ii. The bank obtains a written and reasoned legal opinion(s) representing that in the event of a legal challenge—including one resulting from default, insolvency, liquidation, or similar circumstances—the relevant court and administrative authorities would find the bank's exposure to be such a net amount under:

1. The law of the jurisdiction in which the counterparty is chartered or the equivalent location in the case of noncorporate entities, and if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located;

2. The law that governs the individual contracts covered by the netting contract; and

3. The law that governs the netting contract.

iii. The bank establishes and maintains procedures to ensure that the legal characteristics of netting contracts are kept under review in the light of possible changes in relevant law.

iv. The bank maintains in its files documentation adequate to support the netting of rate contracts, including a copy of the bilateral netting contract and necessary legal opinions.

b. A contract containing a walkaway clause is not eligible for netting for purposes of calculating the credit equivalent amount.[50]

c. By netting individual contracts for the purpose of calculating its credit equivalent amount, a bank represents that it has met the requirements of this appendix A and all the appropriate documents are in the bank's files and available for inspection by the Federal Reserve. The Federal Reserve may determine that a bank's files are inadequate or that a netting contract, or any of its underlying individual contracts, may not be legally enforceable under any one of the bodies of law described in paragraph 5.a.ii.*1.* through 5.a.ii.*3.* of section III of this appendix A. If such a determination is made, the netting contract may be disqualified from recognition for risk-based capital purposes or underlying individual contracts may be treated as though they are not subject to the netting contract.

d. The credit equivalent amount of rate contracts that are subject to a qualifying bilateral netting contract is calculated by adding (i) the current exposure of the netting contract, and (ii) the sum of the estimates of the potential future credit exposures on all individual contracts subject to the netting contract, estimated in accordance with section III.E.2. of this appendix A.[51]

e. The current exposure of the netting contract is determined by summing all positive and negative mark-to-market values of the individual contracts included in the netting contract. If the net sum of the mark-to-market values is positive, then the current exposure of the netting contract is equal to that sum. If the net sum of the mark-to-market values is zero or negative, then the current exposure of the netting contract is zero. The Federal Reserve may determine that a netting contract qualifies for risk-based capital netting treatment even though certain individual contracts may not qualify. In such instances, the nonqualifying contracts should be treated as individual contracts that are not subject to the netting contract.

f. In the event a netting contract covers contracts that are normally excluded from the

[49] For interest and exchange rate contracts, sufficiency of collateral or guarantees is determined by the market value of the collateral or the amount of the guarantee in relation to the credit equivalent amount. Collateral and guarantees are subject to the same provisions noted under section III.B. of this appendix A. Collateral held against a netting contract is not recognized for capital purposes unless it is legally available to support the single legal obligation created by the netting contract.

[50] A walkaway clause is a provision in a netting contract that permits a non-defaulting counterparty to make lower payments than it would make otherwise under the contract, or no payment at all, to a defaulter or to the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the contract.

[51] For purposes of calculating potential future credit exposure to a netting counterparty for foreign exchange contracts and other similar contracts in which notional principal is equivalent to cash flows, total notional principal is defined as the net receipts falling due on each value date in each currency. The reason for this is that offsetting contracts in the same currency maturing on the same date will have lower potential future exposure as well as lower current exposure.

risk-based ratio calculation—for example, exchange rate contracts with an original maturity of fourteen calendar days or less, or instruments traded on exchanges that require daily payment of variation margin—an institution may elect to consistently either include or exclude all mark-to-market values of such contracts when determining net current exposure.

g. An example of the calculation of the credit equivalent amount for rate contracts subject to a qualifying netting contract is contained in Attachment V of this appendix A.

* * * * *

Attachment IV—Credit Conversion Factors for Off-Balance-Sheet Items for State Member Banks

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Credit Conversion for Interest Rate and Exchange Rate Contracts

1. The credit equivalent amount of a rate contract is the sum of the current credit exposure of the contract and an estimate of potential future increases in credit exposure. The current exposure is the positive mark-to-market value of the contract (or zero if the mark-to-market value is zero or negative). For rate contracts that are subject to a qualifying bilateral netting contract the current exposure is, generally, the net sum of the positive and negative mark-to-market values of the contracts included in the netting contract (or zero if the net sum of the mark-to-market values is zero or negative). The potential future exposure is calculated by multiplying the effective notional amount of a contract by one of the following credit conversion factors, as appropriate:

Remaining maturity	Interest rate contracts (percent)	Exchange rate contracts (percent)
One year or less	0	1.0
Over one year	0.5	5.0

2. No potential future exposure is calculated for single currency interest rate swaps in which payments are made based upon two floating indices, that is, so called floating/floating or basis swaps. The credit exposure on these contracts is evaluated solely on the basis of their mark-to-mark value. Exchange rate contracts with an original maturity of fourteen days or less are excluded. Instruments traded on exchanges that require daily payment of variation margin are also excluded.

ATTACHMENT V—CALCULATION OF CREDIT EQUIVALENT AMOUNTS FOR INTEREST RATE AND EXCHANGE RATE-RELATED TRANSACTIONS FOR STATE MEMBER BANKS

Type of contract (remaining maturity)	Potential exposure	+		Current exposure	=	Credit equivalent amount
	Notional principal (dollars)	Conversion factor	Potential exposure (dollars)	Mark-to-market value	Current exposure (dollars)	
(1) 120-day forward foreign exchange	5,000,000	.01	50,000	100,000	100,000	150,000
(2) 120-day forward foreign exchange	6,000,000	.01	60,000	−120,000	0	60,000
(3) 3-year single-currency interest-rate swap	10,000,000	.005	50,000	200,000	200,000	250,000
(4) 3-year single-currency fixed/floating interest-rate swap	10,000,000	.005	50,000	−250,000	0	50,000
(5) 7-year cross-currency floating/floating interest-rate swap	20,000,000	.05	1,000,000	−1,300,000	0	1,000,000
Total			1,210,000		300,000	1,510,000

If contracts (1) through (5) above are subject to a qualifying bilateral netting contract, then the following applies:

	Potential future exposure (from above)	+	Net current exposure [1]	=	Credit equivalent amount
(1)	50,000				
(2)	60,000				
(3)	50,000				
(4)	50,000				
(5)	1,000,0000				
Total	1,210,000		0		1,210,000

[1] The total of the mark-to-market values from above is −1,370,000. Since this is a negative amount, the net current exposure is zero.

* * * * *

PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL (REGULATION Y)

1. The authority citation for part 225 is revised to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1831i, 1831p–1, 1843(c)(8), 1844(b), 1972(1), 3106, 3108, 3310, 3331–3351, 3907, and 3909.

2. Appendix A to part 225 is amended by revising:

a. Section III.E.2.;

b. Section III.E.3.;

c. Section III.E.5.;

d. The last heading and subsequent two paragraphs of Attachment IV; and

e. Attachment V.

The revisions read as follows:

Appendix A to Part 225—Capital Adequacy Guidelines for Bank Holding Companies: Risk-Based Measure

* * * * *

III. * * *

E. * * *

2. Calculation of credit equivalent amounts. a. The credit equivalent amount of an off-balance sheet rate contract that is not subject to a qualifying bilateral netting contract in accordance with section III.E.5. of this appendix A is equal to the sum of (i) the current exposure (sometimes referred to as the replacement cost) of the contract; and an (ii) estimate of the potential future credit exposure over the remaining life of the contract.

b. The current exposure is determined by the mark-to-market value of the contract. If the mark-to-market value is positive, then the current exposure is that mark-to-market value. If the mark-to-market value is zero or negative, then the current exposure is zero. Mark-to-market values are measured in dollars, regardless of the currency or currencies specified in the contract, and

should reflect changes in the relevant rates, as well as counterparty credit quality.

c. The potential future credit exposure of a contract, including a contract with a negative mark-to-market value, is estimated by multiplying the notional principal amount of the contract by a credit conversion factors. Banking organizations should, subject to examiner review, use the effective rather than the apparent or stated notional amount in this calculation. The conversion factors are:

Remaining maturity	Interest rate contracts (percent)	Exchange rate contracts (percent)
One year or less	0	1.0
Over one year	0.5	5.0

d. Examples of the calculation of credit equivalent amounts for these instruments are contained in Attachment V of this appendix A.

e. Because exchange rate contracts involve an exchange of principal upon maturity, and exchange rates are generally more volatile than interest rates, higher conversion factors have been established for exchange rate contracts than for interest rate contracts.

f. No potential future credit exposure is calculated for single currency interest rate swaps in which payments are made based upon two floating rate indices, so-called floating/floating or basis swaps; the credit exposure on these contracts is evaluated solely on the basis of their mark-to-market values.

3. *Risk weights.* Once the credit equivalent amount for an interest rate or exchange rate contract has been determined, that amount is assigned to the risk weight category appropriate to the counterparty or, if relevant, to the guarantor or the nature of any collateral.[53] However, the maximum weight that will be applied to the credit equivalent amount of such instruments is 50 percent.

* * * * *

5. *Netting.* a. For purposes of this appendix A, netting refers to the offsetting of positive and negative mark to-market values in the determination of a current exposure to be used in the calculation of a credit equivalent amount. Any legally enforceable form of bilateral netting (that is, netting with a single counterparty) of rate contracts is recognized for purposes of calculating the credit equivalent amount provided that:

i. The netting is accomplished under a written netting contract that creates a single legal obligation, covering all included individual contracts, with the effect that the organization would have a claim to receive, or obligation to receive or pay, only the net amount of the sum of the positive and negative mark-to-market values on included individual contracts in the event that a counterparty, or a counterparty to whom the contract has been validly assigned, fails to perform due to any of the following events: default, bankruptcy, liquidation, or similar circumstances.

ii. The banking organization obtains a written and reasoned legal opinion(s) representing that in the event of a legal challenge—including one resulting from default, bankruptcy, liquidation, or similar circumstances—the relevant court and administrative authorities would find the banking organization's exposure to be such a net amount under:

1. The law of the jurisdiction in which the counterparty is chartered or the equivalent location in the case of noncorporate entities, and if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located;

2. The law that governs the individual contracts covered by the netting contract; and

3. The law that governs the netting contract.

iii. The banking organization establishes and maintains procedures to ensure that the legal characteristics of netting contracts are kept under review in the light of possible changes in relevant law.

iv. The banking organization maintains in its files documentation adequate to support the netting of rate contracts, including a copy of the bilateral netting contract and necessary legal opinions.

b. A contract containing a walkaway clause is not eligible for netting for purposes of calculating the credit equivalent amount.[54]

c. By netting individual contracts for the purpose of calculating its credit equivalent amount, a banking organization represents that it has met the requirements of this appendix A and all the appropriate documents are in the organization's files and available for inspection by the Federal Reserve. The Federal Reserve may determine that a banking organization's files are inadequate or that a netting contract, or any of its underlying individual contracts, may not be legally enforceable under any one of the bodies of law described in paragraph 5.a.ii.*1.* through 5.a.ii.*3.* of section III of this appendix A. If such a determination is made, the netting contract may be disqualified from recognition for risk-based capital purposes or underlying individual contracts may be treated as though they are not subject to the netting contract.

d. The credit equivalent amount of rate contracts that are subject to a qualifying bilateral netting contract is calculated by adding (i) the current exposure of the netting contract, and (ii) the sum of the estimates of the potential future credit exposures on all individual contracts subject to the netting contract, estimated in accordance with section III.E.2. of this appendix A.[55]

e. The current exposure of the netting contract is determined by summing all positive and negative mark-to-market values of the individual contracts included in the netting contract. If the net sum of the mark-to-market values is positive, then the current exposure of the netting contract is equal to that sum. If the net sum of the mark-to-market values is zero or negative, then the current exposure of the netting contract is zero. The Federal Reserve may determine that a netting contract qualifies for risk-based capital netting treatment even though certain individual contracts may not qualify. In such instances, the nonqualifying contracts should be treated as individual contracts that are not subject to the netting contract.

f. In the event a netting contract covers contracts that are normally excluded from the risk-based ratio calculation—for example, exchange rate contracts with an original maturity of fourteen calendar days or less, or instruments traded on exchanges that require daily payment of variation margin—an institution may elect to consistently either include or exclude all mark-to-market values of such contracts when determining net current exposure.

g. An example of the calculation of the credit equivalent amount for rate contracts subject to a qualifying netting contract is contained in Attachment V of this appendix A.

* * * * *

Attachment IV—Credit Conversion Factors for Off-Balance-Sheet Items for Bank Holding Companies

* * * * *

Credit Conversion for Interest Rate and Exchange Rate Contracts

1. The credit equivalent amount of a rate contract is the sum of the current credit exposure of the contract and an estimate of potential future increases in credit exposure. The current exposure is the positive mark-to-market value of the contract (or zero if the mark-to-market value is zero or negative). For rate contracts that are subject to a qualifying bilateral netting contract the current exposure is the net sum of the positive and negative mark-to-market values of the contracts included in the netting contract (or zero if the net sum of the mark-to-market values is zero or negative). The potential future exposure is calculated by multiplying the effective notional amount of a contract by one of the following credit conversion factors, as appropriate:

[53] For interest and exchange rate contracts, sufficiency of collateral or guarantees is determined by the market value of the collateral or the amount of the guarantee in relation to the credit equivalent amount. Collateral and guarantees are subject to the same provisions noted under section III.E. of this appendix A. Collateral held against a netting contract is not recognized for capital purposes unless it is legally available to support the single legal obligation created by the netting contract.

[54] A walkaway clause is a provision in a netting contract that permits a non-defaulting counterparty to make lower payments than it would make otherwise under the contract, or no payment at all, to a defaulter or to the estate of a defaulter even if the defaulter or the estate of the defaulter is a net creditor under the contract.

[55] For purposes of calculating potential future credit exposure to a netting counterparty for foreign exchange contracts and other similar contracts in which notional principal is equivalent to cash flows, total notional principal is defined as the net receipts falling due on each value date in each currency. The reason for this is that offsetting contracts in the same currency maturing on the same date will have lower potential future exposure as well as lower current exposure.

Remaining maturity	Interest rate contracts (percent)	Exchange rate contracts (percent)
One year or less	0	1.0
Over one year	0.5	5.0

2. No potential future exposure is calculated for single currency interest rate swaps in which payments are made based upon two floating indices, that is, so called floating/floating or basis swaps. The credit exposure on these contracts is evaluated solely on the basis of their mark-to-market value. Exchange rate contracts with an original maturity of fourteen days or less are excluded. Instruments traded on exchanges that require daily payment of variation margin are also excluded.

ATTACHMENT V.—CALCULATION OF CREDIT EQUIVALENT AMOUNTS FOR INTEREST RATE AND EXCHANGE RATE-RELATED TRANSACTIONS FOR BANK HOLDING COMPANIES

Type of contract (remaining maturity)	Potential exposure		+	Current exposure	=	Credit equivalent amount
	Notional principal (dollars)	Conversion Factor	Potential exposure (dollars)	Mark-to-market value	Current exposure (dollars)	
(1) 120-day forward foreign exchange	5,000,000	.01	50,000	100,000	100,000	150,000
(2) 120-day forward foreign exchange	6,000,000	.01	60,000	−120,000	0	60,000
(3) 3-year single-currency fixed/floating interest rate swap	10,000,000	.005	50,000	200,000	200,000	250,000
(4) 3-year single-currency fixed/floating interest-rate swap	10,000,000	.005	50,000	−250,000	0	50,000
(5) 7-year cross-currency floating/floating interest-rate swap	20,000,000	.05	1,000,000	−1,300,000	0	1,000,000
Total			1,210,000		300,000	1,510,000

If contracts (1) through (5) above are subject to a qualifying bilateral netting contract, then the following applies:

	Potential future exposure (from above)	+	Net current exposure[1]	=	Credit equivalent amount
(1)	50,000				
(2)	60,000				
(3)	50,000				
(4)	50,000				
(5)	1,000,000				
Total	1,210,000		0		1,210,000

[1] The total of the mark-to-market values from above is −1,370,000. Since this is a negative amount, the net current exposure is zero.

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By order of the Board of Governors of the Federal Reserve System, December 1, 1994.

William W. Wiles,

Secretary of the Board.

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