BOARD OF GOVERNORS

OF THE

FEDERAL RESERVE SYSTEM

WASHINGTON, D.C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 13-23

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TO THE OFFICER IN CHARGE OF SUPERVISION AT EACH FEDERAL RESERVE BANK AND TO CERTAIN INSTITUTIONS SUPERVISED BY THE FEDERAL RESERVE

SUBJECT: Risk Transfer Considerations When Assessing Capital Adequacy – Supplemental Guidance on Consolidated Supervision Framework for Large Financial Institutions (SR letter 12-17/CA letter 12-14)

Applicability: This guidance applies to large financial institutions supervised by the Federal Reserve and does not apply to community banking organizations, which are defined as institutions with total consolidated assets of $10 billion or less.

The purpose of this letter is to provide guidance on how certain risk transfer transactions affect assessments of capital adequacy at large financial institutions (hereafter referred to as firms)[1] covered by the Federal Reserve's *Consolidated Supervision Framework for Large Financial Institutions*.[2] The consolidated supervision framework for these firms is centered on four core areas of supervisory focus related to enhancing a firm's resiliency: capital adequacy and liquidity sufficiency, corporate governance, recovery and resolution planning, and management of core business lines. This letter provides clarification on supervisory expectations when assessing a firm's capital adequacy in certain circumstances when the risk-based capital framework may not fully capture the residual risks of a transaction.[3]

Risk mitigation techniques can reduce a firm's level of risk. In general, the Federal Reserve views a firm's engagement in risk-reducing transactions as a sound risk management practice. There are, however, certain risk-reducing transactions for which the risk-based capital framework may not fully capture the residual risks that a firm faces on a post-transaction basis. As a result of recent inquiries and discussions with market participants, the Federal Reserve has

[1] This guidance applies to large financial institutions that are domestic bank and savings and loan holding companies with consolidated assets of $50 billion or more and foreign banking organizations with combined assets of U.S. operations of $50 billion or more.

[2] Refer to SR letter 12-17/CA letter 12-14, "Consolidated Supervision Framework for Large Financial Institutions."

[3] See 12 CFR 217. The risk-based capital framework establishes risk-based and leverage capital requirements for banking organizations, including top-tier savings and loan holding companies, except those that are substantially engaged in insurance underwriting or commercial activities. The guidance in this letter would apply to such entities at such time as risk-based and leverage capital requirements become applicable to them.

identified specific characteristics of risk transfer transactions that give rise to this concern and on which further guidance is needed, including cases in which:

- A firm transfers the risk of a portfolio to a counterparty (which may be a thinly capitalized special purpose vehicle (SPV)) that is unable to absorb losses equal to the risk-based capital requirement for the risk transferred; or
- A firm transfers the risk of a portfolio to an unconsolidated, "sponsored" affiliate entity of the firm (which also may be an SPV).

In cases involving unaffiliated counterparties, while the transactions may result in a significant reduction in a firm's risk-weighted assets and associated capital requirements under the regulatory capital framework, the firm may nonetheless face residual risks. These residual risks arise because the effectiveness of a firm's hedge involving a thinly capitalized SPV counterparty would be limited to the loss absorption capacity of the SPV itself. In cases involving unconsolidated "sponsored" affiliates of the firm, the residual risk arises from the implicit obligation the sponsoring firm may have to provide support to the affiliate in times of stress. This letter addresses how the Federal Reserve supervisory staff will view such risk-reducing transactions[4] in evaluating a firm under the Board's capital plan rule and the associated annual Comprehensive Capital Analysis and Review (CCAR).[5]

In the case of a risk transfer transaction with a non-affiliated, limited-recourse SPV or other counterparty with limited loss-absorption capacity, Federal Reserve supervisory staff will evaluate the difference between the amount of capital required for the hedged exposures before the risk transfer transaction and the counterparty's loss-absorbing resources. When evaluating capital adequacy, including in the context of CCAR, supervisory staff will evaluate whether a firm holds sufficient capital in addition to its minimum regulatory capital requirements to cover this difference.[6] In addition, when a firm engages in such a risk transfer transaction, the firm should be able to demonstrate that it reflects the residual risk in its internal assessment of capital adequacy and maintains sufficient capital to address such risk. In this regard, a commitment by a third party to provide additional capital in a period of financial stress would not be counted toward the loss-absorbing capacity of the counterparty.

> *Example*: A firm has a $100 portfolio that has a capital requirement of $8. If the firm undertakes a transaction to transfer the risk of this portfolio to an unaffiliated SPV with paid-in capital of $3, then the firm would need to be able to demonstrate that, in addition to meeting its minimum regulatory capital requirements, the firm has sufficient capital to cover the $5 difference between the SPV's capital and the capital requirement associated with the portfolio.

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[4] While the cases described in this letter are examples, the principles set forth should apply to other transactions that call into question the degree to which risk transfer has occurred.

[5] See 12 CFR 225.8(d)(2)(i). For additional guidance on CCAR, refer to the Federal Reserve's website at http://www.federalreserve.gov/bankinforeg/ccar.htm. The capital plan rule and CCAR apply only to bank holding companies with total consolidated assets of $50 billion or more.

[6] Supervisory staff may also analyze whether the counterparty has liabilities in addition to the specific risk transfer transaction.

In the case of risk transfer to an unconsolidated, "sponsored" affiliated entity, the nature of the firm's relationship with the entity calls into question the degree of risk transfer in the transaction. Firms are discouraged from entering into such transactions, which generally do not involve effective risk transfer because of the sponsored entity's ongoing relationship with the firm and, as noted above, the implicit obligation that the firm may have to provide capital to the sponsored entity in a period of financial stress affecting the sponsored entity. Firms engaging in such transactions should presume for the purpose of their internal capital adequacy assessment as well as for capital planning purposes that no risk transfer has occurred.

Supervisors will strongly scrutinize risk transfer transactions that result in substantial reductions in risk-weighted assets, including in supervisors' assessment of a firm's overall capital adequacy, capital planning, and risk management through CCAR. Based on an assessment of the risks retained by the firm, the Board may in particular cases determine not to recognize a transaction as a risk mitigant for risk-based capital purposes.[7] Firms should bring these types of risk transfer transactions to the attention of their senior management and supervisors. Supervisors will evaluate whether a firm can adequately demonstrate that the firm has taken into account any residual risks in connection with the transaction.

Reserve Banks are asked to distribute this letter and attachment to large financial institutions supervised by the Federal Reserve in their Districts, as well as to the appropriate supervisory and examination staff. Questions regarding the attached guidance should be addressed to the following Capital & Regulatory Policy staff: Constance M. Horsley, Manager, at (202) 452-5239; or Mona T. Elliot, Senior Supervisory Financial Analyst, at (202) 912-4688. In addition, questions may be sent via the Board's public website.[8]

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Director

Cross-References:

- SR letter 12-17/CA letter 12-14, "Consolidated Supervision Framework for Large Financial Institutions"

[7] See generally 12 CFR 217.1(d)(1), (d)(3), and (d)(5). In addition, under the Board's current capital adequacy guidelines for bank holding companies and state member banks (banking organizations), the Board may determine that the regulatory capital treatment for a banking organization's exposure or other relationship to an entity not consolidated on the banking organization's balance sheet is not commensurate with the actual risk relationship of the banking organization to the entity. In making this determination, the Board may require the banking organization to treat the entity as if it were consolidated onto the balance sheet of the banking organization for risk-based capital purposes and calculate the appropriate risk-based capital ratios accordingly, all as specified by the Board. 12 CFR parts 208 and 225, Appendix A, section I.

[8] See http://www.federalreserve.gov/apps/contactus/feedback.aspx.