

A-IRB capital purposes only where the reference obligation on which the protection is based is the same as the underlying obligation except where: (1) the reference obligation ranks *pari passu* with or is more junior than the underlying obligation, and (2) the underlying obligation and reference obligation share the same obligor and legally enforceable cross-default or cross-acceleration clauses are in place.

Treatment of Maturity Mismatch

The Agencies are proposing to recognize on a discounted basis guarantees and credit derivatives that have a shorter maturity than the hedged obligation. A guarantee or credit derivative with less than one-year remaining maturity that does not have a matching maturity to the underlying obligation, however, would not be recognized. The formula for discounting the amount of a maturity-mismatched hedge that is recognized is proposed as follows:

$$P_a = P * t/T$$

Where:

P_a denotes the value of the credit protection adjusted for maturity mismatch;

P denotes the amount of the credit protection;

t denotes the lesser of T and the remaining maturity of the hedge arrangement, expressed in years; and

T denotes the lesser of five and the remaining maturity of the underlying obligation, expressed in years.

The Agencies have concerns that the proposed formulation does not appropriately reflect distinctions between bullet and amortizing underlying obligations. Comment is sought on the best way of making such a distinction, as well as more generally on alternative methods for dealing with the reduced credit risk coverage that results from a maturity mismatch.

Treatment of Counterparty Risk for Credit Derivative Contracts

The Agencies are proposing that the EAD for derivative contracts included in either the banking book or trading book be determined in accordance with the rules for calculating the credit equivalent amount for such contracts set forth under the general risk-based capital rules. The Agencies are proposing to include in the types of derivative contracts covered under these rules credit derivative contracts recorded in the trading book. Accordingly, where a banking organization buys or sells a credit derivative through its trading book, a counterparty credit risk capital charge

would be imposed based on the replacement cost plus the following add-on factors for PFE:

Total return or credit default swap	Protection buyer (percent)	Protection seller (percent)
Qualifying Reference Obligation*	5	**5
Non-Qualifying Reference Obligation*	10	**10

*The definition of qualifying would be the same as for the "qualifying" category for the treatment of specific risk for covered debt positions under the market risk capital rules.

**The protection seller of a credit default swap would only be subject to the add-on factor where the contract is subject to close-out upon the insolvency of the protection buyer while the underlying obligor is still solvent.

The Agencies also are considering applying a counterparty credit risk charge on all credit derivatives that are marked-to-market, including those recorded in the banking book. Such a treatment would promote consistency with other OTC derivatives, which are assessed the same counterparty credit risk charge regardless of where they are booked.

Further, the Agencies note that, if credit derivatives booked in the banking book are not assessed a counterparty credit risk charge, banking organizations would be required to exclude these derivatives from the net current exposure of their other derivative exposures to a counterparty for purposes of determining regulatory capital requirements. On balance, the Agencies believe a better approach would be to align the net derivative exposure used for capital purposes with that used for internal risk management purposes to manage counterparty risk exposure and collateralization thereof. This approach would suggest imposing a counterparty risk charge on all credit derivative exposures that are marked to market, regardless of where they are booked.

The Agencies are seeking industry views on the PFE add-ons proposed above and their applicability. Comment is also sought on whether different add-ons should apply for different remaining maturity buckets for credit derivatives and, if so, views on the appropriate percentage amounts for the add-ons in each bucket.

Equity Exposures

Banking organizations using the A-IRB approach for any credit exposure would be required to use an internal models market-based approach to calculate regulatory capital charges for equity exposures. Minimum quantitative and qualitative

requirements for using an internal model would have to be met on an ongoing basis. An advanced approach banking organization that is transitioning into an internal models approach to equity exposures or that fails to demonstrate compliance with the minimum operational requirements for using an internal models approach to equity exposures would be required to develop a plan for compliance, obtain approval of the plan from its primary Federal supervisor, and implement the plan in a timely fashion. In addition, a banking organization's primary Federal supervisor would have the authority to impose additional operational requirements on a case-by-case basis. Until it is fully compliant with all applicable requirements, the banking organization would apply a minimum 300 percent risk weight to all publicly traded equity investments (that is, equity investments that are traded on a nationally recognized securities exchange) and a minimum 400 percent risk weight to all other equity investments.

Positions Covered

All equity exposures held in the banking book, along with any equity exposures in the trading book that are not currently subject to a market risk capital charge, would be subject to the A-IRB approach for equity exposures. In general, equity exposures are distinguished from other types of exposures based on the economic substance of the exposure. Equity exposures would include both direct and indirect ownership interests, whether voting or non-voting, in the assets or income of a commercial enterprise or financial institution that are not consolidated or deducted for regulatory capital purposes. Holdings in funds containing both equity investments and non-equity investments would be treated either as a single investment based on the majority of the fund's holdings or, where possible, as separate and distinct investments in the fund's component holdings based on a "look-through approach" (that is, based on the individual component holdings).

An instrument generally would be considered to be an equity exposure if it (1) would qualify as Tier 1 capital under the general risk-based capital rules if issued by a banking organization; (2) is irredeemable in the sense that the return of invested funds can be achieved only by the sale of the investment or sale of the rights to the investment or in the event of the liquidation of the issuer; (3) conveys a residual claim on the assets or income