Capital Considerations for Bank Securitizers and Investors

On July 2, 2013, the Board of Governors of the Federal Reserve System (the Board) adopted new capital requirements[1] implementing the so-called Basel III standards for domestic banks, federal savings associations and bank and savings and loan holding companies.[2] On July 9, 2013, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency added their approval. These standards apply beginning on January 1, 2014, to banking organizations (other than savings and loan holding companies) that compute their capital using the advanced approaches; they apply beginning on January 1, 2015, to all other covered institutions except bank holding company subsidiaries of non-US banks that are currently relying on the Board's Supervision and Regulation Letter 01-1, which are not required to comply until July 21, 2015.

In addition to provisions relating to capital generally, these requirements contain provisions relating specifically to the capital requirements associated with securitization exposures of covered banking organizations in their capacities as both securitizers and investors. The manner in which required capital is calculated depends upon, among other things, (i) whether the covered banking organization uses the standardized approach or the advanced approaches to compute its capital, and (ii) whether the securitization exposure is a traditional securitization, a synthetic securitization or a resecuritization. Although in general the requirements relate to exposures of all kinds, some of the provisions by their nature will only apply to an exposure retained by a securitizer.

Determining whether a securitization exposure exists and the category to which it should be assigned requires a covered banking organization to examine whether (i) the relevant pool consists of one or more financial assets, (ii) there is more than one layer of exposures, (iii) any exposure in any layer is tranched, and (iv) any special interpretations apply in reaching an analytical conclusion, and which risk weights apply to the various components of the exposures. Normally, the banking organization conducting such an evaluation will already have determined whether the standardized approach or the advanced approaches apply in calculating the resulting capital requirements.

The securitization provisions in the Basel III Release are divided into two principal parts. One part contains the so-called advanced (i.e., the individualized and mathematically more complicated) approaches[3] used in determining capital requirements; the other contains the so-called standardized

[1] Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, currently available here (the Basel III Release).

[2] The Basel III Release excludes "certain savings and loan holding companies that are substantially engaged in insurance underwriting or commercial activities...." Basel III Release, footnote 2.

[3] Generally, banks that apply the advanced approaches have consolidated assets of $250 billion or more and consolidated total on-balance sheet foreign exposure of $10 billion or more, or are subsidiaries of an institution that applies the advanced approaches.

approach. Both of these parts are in the portion of the final rule referred to as the Common Rule, which contains the provisions that apply generally to all covered institutions. Each regulator also has adopted certain other provisions that apply only to the institutions for which it is responsible. Despite their differences in complexity, however, the advanced and standardized approaches both rely on many of the same fundamental definitions and principles. This alert will first describe what the two types of approaches have in common and then briefly summarize their differences, which largely relate to the manner in which the capital requirements are calculated for a given securitization exposure.

General Definitions

For an exposure to be subject to the special capital rules for securitizations, it must be a "securitization exposure," which is defined as:

(1) An on-balance sheet or off-balance sheet credit exposure (including credit-enhancing representations and warranties)[4] that arises from a traditional securitization or synthetic securitization (including a resecuritization), or

(2) An exposure that directly or indirectly references a securitization exposure described in paragraph (1) of this definition.[5]

In other words, treatment as a securitization does not depend on whether an exposure is on- or off-balance sheet,[6] on whether it is direct or indirect, or even on whether it is structural in nature, but rather on the substance of the arrangements. The term "exposure" itself is not defined in isolation in the Common Rule and must be understood in terms of the way it is treated in the various definitions, formulas and procedures; however, it roughly refers to the risk of loss associated with an asset.

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4 "Credit-enhancing representations and warranties means representations and warranties that are made or assumed in connection with a transfer of underlying exposures (including loan servicing assets) and that obligate a [BANK] to protect another party from losses arising from the credit risk of the underlying exposures. Credit-enhancing representations and warranties include provisions to protect a party from losses resulting from the default or nonperformance of the counterparties of the underlying exposures or from an insufficiency in the value of the collateral backing the underlying exposures. Credit-enhancing representations and warranties do not include: (1) Early default clauses and similar warranties that permit the return of, or premium refund clauses covering, 1-4 family residential first mortgage loans that qualify for a 50 percent risk weight for a period not to exceed 120 days from the date of transfer. These warranties may cover only those loans that were originated within 1 year of the date of transfer; (2) Premium refund clauses that cover assets guaranteed, in whole or in part, by the U.S. Government, a U.S. Government agency or a government-sponsored enterprise, provided the premium refund clauses are for a period not to exceed 120 days from the date of transfer; or (3) Warranties that permit the return of underlying exposures in instances of misrepresentation, fraud, or incomplete documentation." Section __.2 of the Common Rule (i.e., the provisions that will be common to the applicable regulations of each Federal bank regulator) set forth in the Basel III Release. Only the provisions in the Common Rule are discussed in this alert.

5 Section __.2 of the Common Rule.

6 In this context, the terms off-balance sheet and on-balance sheet do not refer to the process of transferring assets to a special purpose entity; rather, they refer to whether the remaining exposure is treated for bank accounting purposes as off- or on-balance sheet. For example, the commitment represented by a liquidity facility would generally be treated as off-balance sheet.

Traditional Securitizations

A "traditional securitization" is:

> … a transaction in which: (1) All or a portion of the credit risk of one or more underlying exposures is transferred to[7] one or more third parties other than through the use of credit derivatives or guarantees; (2) The credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority; (3) Performance of the securitization exposures depends upon the performance of the underlying exposures; (4) All or substantially all of the underlying exposures are financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, mortgage-backed securities, other debt securities, or equity securities); …[8]

The effect of this definition is to treat as a traditional securitization a tranched, non-derivative exposure to financial assets that depends on the performance of those assets.

Synthetic Securitizations

Although a credit derivative is not a traditional securitization, it can be a synthetic securitization, which is defined as:

> … a transaction in which: (1) All or a portion of the credit risk of one or more underlying exposures is retained or transferred to one or more third parties through the use of one or more credit derivatives or guarantees (other than a guarantee that transfers only the credit risk of an individual retail exposure); (2) The credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority; (3) Performance of the securitization exposures depends upon the performance of the underlying exposures; and (4) All or substantially all of the underlying exposures are financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, mortgage-backed securities, other debt securities, or equity securities).[9]

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7 Transferring an exposure to someone else means taking an action that creates a securitization exposure for which the other person must determine a capital requirement.

8 *Ibid.* The full definition includes transactions entered into by certain types of entities, as described below.

9 *Ibid.* In the Preamble to the Basel III Release, the Board distinguishes between the effects of two kinds of guarantees: "In response to the proposal, commenters requested that the agencies provide an exemption for guarantees that tranche credit risk under certain mortgage partnership finance programs, such as certain programs provided by the FHLBs, whereby participating member banking organizations provide credit enhancement to a pool of residential mortgage loans that have been delivered to the FHLB. The agencies believe that these exposures that tranche credit risk meet the definition of a synthetic securitization and that the risk of such exposures would be appropriately captured under the securitization framework. In contrast, mortgage-backed pass-through securities (for example, those guaranteed by FHLMC or FNMA) that feature various maturities but do not involve tranching of credit risk do not meet the definition of a securitization exposure. Only those MBS that involve tranching of credit risk are considered to be securitization exposures." Basel III Release at 346-7.

Neither in the case of a traditional securitization nor in that of a synthetic securitization does securitization treatment depend on the transfer of all credit risk. In other words, each securitizer or any investor that is subject to the Basel III Release would be required to determine whether it has any exposure and, if so, how much. Nor is a pool of financial assets required. Instead, there must be a tranched exposure to at least one financial asset,[10] which means that there must be at least two distinct exposures to the underlying financial asset or assets, each of which exposures must have a different seniority level.[11]

Resecuritizations

Exposures to resecuritizations receive capital treatment that differs from that accorded to other securitization exposures. The presence or absence of tranches at two levels determines whether a resecuritization exposure exists.

> Resecuritization means a securitization which has more than one underlying exposure and in which one or more of the underlying exposures is a securitization exposure.
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> Resecuritization exposure means: (1) An on- or off-balance sheet exposure to a resecuritization; [or] (2) An exposure that directly or indirectly references a resecuritization exposure; …[12]

The effect of these definitions relating to resecuritization exposure is to require two levels of exposure, each of which must have some tranching. If there is only one level of exposure, or if one of the two levels of exposure is not tranched, then no resecuritization exists. It is also not a requirement for the existence of resecuritization that everything in the underlying exposure be tranched; rather, only some of that exposure must be tranched. The Preamble to the Basel III Release concludes from these definitions that neither the retranching of a single underlying exposure, such as a real estate mortgage investment conduit (a Re-REMIC), nor the creation of a tranched investment to hold pass-through securities that did not themselves tranche credit protection, constitutes a resecuritization.[13]

ABCP Conduits

Similar considerations apply to a typical multi-seller asset-backed commercial paper conduit (ABCP Conduit). The provider of a liquidity facility to an individual seller's pool of wholesale exposures creates a tranched exposure, according to the Basel III Release, but does not create a resecuritization in doing so, since the wholesale exposures are not themselves tranched; however, a program-wide credit enhancement that covers fewer than all losses (a Tranched Enhancement) does resecuritize if the partially covered

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[10] "However, the agencies believe that limiting the securitization framework to exposures backed by a pool of assets would exclude tranched credit risk exposures that are appropriately captured under the securitization framework, such as certain first loss or other tranched guarantees provided to a single underlying exposure." *Id.* at 341.

[11] "Tranche means all securitization exposures associated with a securitization that have the same seniority level." §__.2 of the Common Rule.

[12] *Ibid.* The remainder of the definition of "resecuritization exposure" has been omitted as irrelevant in this context.

[13] Basel III Release at 348.

program itself contains at least one securitization exposure, as it would, for example, if it contained a seller pool covered by the kind of liquidity facility described above.[14] As a consequence, a single class of commercial paper issued by an ABCP Conduit would appear to constitute a resecuritization exposure in the hands of an investor subject to the Basel III Release if the ABCP Conduit both contained at least one securitization exposure and were covered by a Tranched Enhancement; however, it would not constitute a resecuritization exposure if the applicable credit enhancement fully covered the entire program.

The Preamble appears, however, to do more than just conclude that 100 percent credit-enhanced commercial paper does not constitute a resecuritization exposure. It appears, in fact, to treat commercial paper that is fully supported by the Conduit's sponsor as not being a securitization exposure at all, even if the ABCP Conduit contains underlying securitization exposures.[15] Although the Preamble seems potentially ambiguous on this point, and that potential ambiguity is exacerbated by the generality of the concept of securitization exposure used in the Basel III Release,[16] the view that such commercial paper does not represent a securitization exposure at all is supported by the reference to the credit quality of the sponsor and to the fact that the risk to which the holders of commercial paper are exposed is described as the risk that the bank will default. This conclusion appears, however, to be implicitly contrary to the wording of Common Rule §__.42(c)(3), which treats such support as a securitization exposure.[17] This apparent conflict is explained by noting several facts about the Common Rule. The definition of "resecuritization exposure" in §__.2 excludes commercial paper issued by an ABCP Conduit if it enjoys either of two types of credit support, program-wide credit enhancement that does not satisfy the definition of "resecuritization exposure" or liquidity support by the sponsor in a fashion that effectively exposes holders "to the default risk of the sponsor instead of the underlying exposures."[18] The effect of this

14 *Id.* at 348-9. The Basel III Release expressly refuses to create a de minimis exception for ABCP Conduits whose securitization exposures did not exceed a certain percentage of their total assets. The capital treatment that applies to the provider of the liquidity facility is described in the discussion of off-balance sheet exposures.

15 "In addition, if the conduit in this example funds itself entirely with a single class of commercial paper, then the commercial paper generally is not a resecuritization exposure if, as noted above, either (1) the program-wide credit enhancement does not meet the definition of a resecuritization exposure or (2) the commercial paper is fully supported by the sponsoring banking organization. When the sponsoring banking organization fully supports the commercial paper, the commercial paper holders effectively are exposed to default risk of the sponsor instead of the underlying exposures, and the external rating of the commercial paper is expected to be based primarily on the credit quality of the banking organization sponsor, thus ensuring that the commercial paper does not represent a tranched risk position." *Id.* at 349. The definition of "ABCP program sponsor" is discussed below under "Characterizations of the Parties."

16 "Provided there is tranching of credit risk, securitization exposures could include, among other things, ABS and MBS, loans, lines of credit, liquidity facilities, financial standby letters of credit, credit derivatives and guarantees, loan servicing assets, servicer cash advance facilities, reserve accounts, credit-enhancing representations and warranties, and credit-enhancing interest-only strips (CEIOs). Securitization exposures also include assets sold with retained tranches." *Id.* at 341.

17 "For an off-balance sheet securitization exposure to an ABCP program, such as an eligible ABCP liquidity facility, the notional amount may be reduced to the maximum potential amount that the [BANK] could be required to fund given the ABCP program's current underlying assets (calculated without regard to the current credit quality of those assets)."

18 Section __.2 of the Common Rule.

second exclusion is not only to eliminate resecuritization treatment but also to redirect the source of the commercial paper holder's exposure from the ABCP Conduit to the sponsor.[19] Section __.42(c)(3) of the Common Rule, on the other hand, treats the liquidity facility as a securitization exposure of the facility provider only.

Certain Entities Excluded

To alleviate some of the concerns about the breadth with which "securitization exposure" is defined, the definition of "traditional securitization" specifically excludes operating companies, even those with a large percentage of financial assets, and a number of pooled investment vehicles. The latter category includes small business investment companies as defined in the Small Business Investment Act, community development investments as defined in the National Bank Act, investment funds,[20] collective investment funds permissible for depository institutions, US and non-US employee benefit plans regulated pursuant to applicable legislation, and SEC-registered US and similar non-US investment companies.[21] The responsible bank regulatory agency may also make further exceptions.

Characterizations of the Parties

Characterization as an "originating banking organization" with respect to a securitization results in the application of certain provisions of the Common Rule to that bank, including the operational requirements described below, the definitions of "eligible clean-up call" and "investing bank,"[22] and the provisions relating to the recognition of certain hedges. The "originating" bank with respect to a traditional securitization is the bank that "(1) [d]irectly or indirectly originated or securitized the underlying exposures included in the securitization; or (2) [s]erves as an ABCP program sponsor to the

[19] Neither the Preamble nor the Common Rule clarifies exactly what distinguishes program-wide credit enhancement that does not satisfy the definition of "resecuritization exposure" from the type of liquidity support that changes the source of an exposure.

[20] "Investment fund" is defined as "a company: (1) [w]here all or substantially all of the assets of the company are financial assets; and (2) [t]hat has no material liabilities." Section __.2 of the Common Rule. This essentially describes pooled investments held by equity investors without consideration of their regulatory status. For the treatment of pass-through certificates, see pp. 346-7 of the Preamble, which essentially describes how some pooled investments are treated like "investment funds" as defined and others are not, in each case on the basis of a tranching analysis rather than on the basis of whether the pooled investment has material liabilities: "In response to the proposal, commenters requested that the agencies provide an exemption for guarantees that tranche credit risk under certain mortgage partnership finance programs, such as certain programs provided by the FHLBs, whereby participating member banking organizations provide credit enhancement to a pool of residential mortgage loans that have been delivered to the FHLB. The agencies believe that these exposures that tranche credit risk meet the definition of a synthetic securitization and that the risk of such exposures would be appropriately captured under the securitization framework. In contrast, mortgage-backed pass-through securities (for example, those guaranteed by FHLMC or FNMA) that feature various maturities but do not involve tranching of credit risk do not meet the definition of a securitization exposure. Only those MBS that involve tranching of credit risk are considered to be securitization exposures."

[21] Also excluded from the definition of "traditional securitization" is "[a] synthetic exposure to the capital of a financial institution to the extent deducted from capital under §__.22…" Section __.2 of the Common Rule. Section __.22 of the Common Rule deals with deductions from capital.

[22] A bank holding a securitization exposure that is not an originating bank.

securitization."[23] A bank is treated as an ABCP program sponsor if it satisfies any of the following criteria: It (i) establishes the program; (ii) approves the sellers who will be funded by the issuance of commercial paper; (iii) approves the exposures that the program will purchase; or (iv) administers the program.[24]

Operational and Diligence Requirements

In addition to the common definitional framework described above, the standardized and advanced approaches share operational and diligence requirements, which the Basel III Release describes (at least with respect to the diligence requirements) as "generally consistent with the goal of the agencies' investment permissibility requirements."[25]

Operational Requirements

The applicable operational requirements vary somewhat, depending on whether the securitization is traditional or synthetic; in addition, it is something of a misnomer to refer to them as operational, since they are largely accounting and structural in nature. An originating banking organization that satisfies all of the operational requirements in connection with a securitization is permitted to use the approaches in the securitization provisions of the Common Rule to calculate its capital requirements for the securitization exposure that it retains. If it does not satisfy all of those requirements and the securitization is traditional, it must "hold risk-based capital against the transferred exposures as if they had not been securitized and must deduct from common equity tier 1 capital any after-tax gain-on-sale resulting from the transaction."[26] If the securitization is synthetic, the bank suffers a different consequence: it may not recognize the hedging effect of collateral, a guarantee or a credit derivative (each of which is referred to as a "credit risk mitigant").[27]

For traditional securitizations, the following conditions must be satisfied for securitization treatment to be available to the bank that purported to transfer exposures:

(1) The exposures are not reported on the [BANK]'s consolidated balance sheet under GAAP;

(2) The [BANK] has transferred to one or more third parties credit risk associated with the underlying exposures;

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23 Section__.2 of the Common Rule.

24 *Ibid.* Administration includes "monitoring the underlying exposures, underwriting or otherwise arranging for the placement of debt or other obligations issued by the program, compiling monthly reports, or ensuring compliance with the program documents and with the program's credit and investment policy." *Ibid.*

25 Basel III Release at 351.

26 Section __.41(a) of the Common Rule. This is an example of a provision affecting the (purported) securitizer rather than the investor.

27 In addition, if a bank decides not to recognize the effect of collateral, a guarantee or a credit derivative with respect to a synthetic securitization, it must treat the securitization just as it would if the operational requirements were not met. Section __.41(b) of the Common Rule.

(3) Any clean-up calls relating to the securitization are eligible clean-up calls;[28] and

(4) The securitization does not: (i) Include one or more underlying exposures in which the borrower is permitted to vary the drawn amount within an agreed limit under a line of credit; and (ii) Contain an early amortization provision.[29]

For synthetic securitizations, a somewhat different set of standards must be met, in this case in order to be able to recognize in the calculation of exposures and capital requirements the hedging effect of any credit risk mitigant:

(1) The credit risk mitigant is: (i) Financial collateral; (ii) A guarantee that meets all criteria as set forth in the definition of "eligible guarantee" in §__.2, except for the criteria in paragraph (3) of that definition; or (iii) A credit derivative that meets all criteria as set forth in the definition of "eligible credit derivative" in §__.2, except for the criteria in paragraph (3) of the definition of "eligible guarantee" in §__.2.

(2) The [BANK] transfers credit risk associated with the underlying exposures to one or more third parties, and the terms and conditions in the credit risk mitigants employed do not include provisions that: (i) Allow for the termination of the credit protection due to deterioration in the credit quality of the underlying exposures; (ii) Require the [BANK] to alter or replace the underlying exposures to improve the credit quality of the underlying exposures; (iii) Increase the [BANK]'s cost of credit protection in response to deterioration in the credit quality of the underlying exposures; (iv) Increase the yield payable to parties other than the [BANK] in response to a deterioration in the credit quality of the underlying exposures; or (v) Provide for increases in a retained first loss position or credit enhancement provided by the [BANK] after the inception of the securitization;

(3) The [BANK] obtains a well-reasoned opinion from legal counsel that confirms the enforceability of the credit risk mitigant in all relevant jurisdictions; and

(4) Any clean-up calls relating to the securitization are eligible clean-up calls.[30]

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28 An eligible clean-up call is "…a clean-up call that: (1) [i]s exercisable solely at the discretion of the originating [BANK] or servicer; (2) [i]s not structured to avoid allocating losses to securitization exposures held by investors or otherwise structured to provide credit enhancement to the securitization; and (3)(i) [f]or a traditional securitization, is only exercisable when 10 percent or less of the principal amount of the underlying exposures or securitization exposures (determined as of the inception of the securitization) is outstanding; or (ii) [f]or a synthetic securitization, is only exercisable when 10 percent or less of the principal amount of the reference portfolio of underlying exposures (determined as of the inception of the securitization) is outstanding." Section __.2 of the Common Rule.

29 Section __.41(a) of the Common Rule. Identical provisions are also contained in §__.141(a), which relates to advanced approaches banks. Note the presence of the word "and" between clauses (i) and (ii). The apparent consequences of this provision are intentional: "The agencies believe that this treatment is appropriate given the lack of risk transference in securitizations of revolving underlying exposures with early amortization provisions." Preamble to the Basel III Release, pp. 354-5.

30 Section __.41(b) of the Common Rule. Identical provisions are also contained in §__.141(b), which relates to advanced approaches banks.

Diligence Requirements

In addition to the essentially structural component of the operational requirements described above, diligence requirements must be satisfied as well. The failure to satisfy the applicable diligence requirements leads to the imposition of a uniform 1250 percent risk weight to the relevant securitization exposure.

A securitizing or investing bank must perform diligence sufficient to demonstrate to its regulator that it has "a comprehensive understanding of the features of a securitization exposure that would materially affect the performance of the exposure."[31] Such sufficiency can be attained by:

(i) Conducting an analysis of the risk characteristics of a securitization exposure prior to acquiring the exposure, and documenting such analysis within three business days after acquiring the exposure, considering: (A) Structural features of the securitization that would materially impact the performance of the exposure…;[32] (B) Relevant information regarding the performance of the underlying credit exposure(s)…;[33] (C) Relevant market data of the securitization…;[34] and (D) For resecuritization exposures, performance information on the underlying securitization exposures…;[35] and

(ii) On an on-going basis (no less frequently than quarterly), evaluating, reviewing, and updating as appropriate the analysis required under paragraph (c)(1) of this section for each securitization exposure.[36]

The Mechanics of Calculating Capital – The Standardized Approach

A bank that uses the standardized approach must first sort its exposures into a number of categories and then choose one of the permissible means of calculating the risk weights applicable to those exposures. Those risk weights are then multiplied by the applicable exposure amounts to derive the risk-adjusted amounts with respect to which the required percentage of capital must be maintained.

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[31] Section __.41(c)(1) of the Common Rule.

[32] "…for example, the contractual cash flow waterfall, waterfall-related triggers, credit enhancements, liquidity enhancements, fair value triggers, the performance of organizations that service the exposure, and deal-specific definitions of default…" Section 41(c)(2) of the Common Rule.

[33] "…for example, the percentage of loans 30, 60, and 90 days past due; default rates; prepayment rates; loans in foreclosure; property types; occupancy; average credit score or other measures of creditworthiness; average LTV ratio; and industry and geographic diversification data on the underlying exposure(s)…" *Ibid.*

[34] "…for example, bid-ask spread, most recent sales price and historic price volatility, trading volume, implied market rating, and size, depth and concentration level of the market for the securitization…" *Ibid.*

[35] "…for example, the issuer name and credit quality, and the characteristics and performance of the exposures underlying the securitization exposures…" *Ibid.*

[36] *Ibid.* Identical provisions apply to advanced approaches banks under §__.141(c)(2) of the Common Rule.

After-tax gains-on-sale resulting from securitizations must be deducted directly from common equity tier 1 capital, and the portion of a credit-enhancing interest-only strip that does not constitute after-tax gain-on-sale must be assigned a risk weight of 1250 percent.

Other categories of exposure are distinguished from one another for the purpose of determining their amount. In general, other than as set forth above, the amount of an **on-balance sheet** securitization exposure is its carrying value, but special values are prescribed for available-for-sale or held-to-maturity securities for which an accumulated other comprehensive income opt-out has been made;[37] repo-style transactions;[38] eligible margin loans;[39] OTC derivative contracts;[40] and cleared transactions.[41]

The amount of an **off-balance sheet** securitization exposure "that is not a repo-style transaction, eligible margin loan, cleared transaction (other than a credit derivative), or an OTC derivative contract (other than a credit derivative) is the notional amount of the exposure."[42] For eligible ABCP liquidity facilities, however, other rules apply. The exposure amount may equal (i) the maximum amount a bank could be required to fund, (ii) 50% of the notional amount if the simplified supervisory formula approach (SSFA) is not used to calculate required capital, or (iii) 100 percent of the notional amount if the SSFA applies.[43] The provision of implicit support beyond what is required contractually leads to the requirement that capital be calculated as if no securitization had taken place.[44] The effect of credit risk mitigants is

[37] Pursuant to such a (one-time) election, a bank may elect not to include accumulated other comprehensive income in common equity tier 1 capital. This opt-out does not apply to accumulated net gains and losses on cash flow hedges related to items that are not fair-valued on the balance sheet. The amount of such an exposure is its "carrying value (including net accrued but unpaid interest and fees), less any net unrealized gains on the exposure and plus any net unrealized losses on the exposure." Section __.42(c)(2) of the Common Rule.

[38] This category includes repurchase and reverse repurchase agreements and securities borrowing and lending transactions, "including [transactions] in which the [BANK] acts as agent for a customer and indemnifies the customer against loss," provided a number of conditions are satisfied relating to the liquidity and bankruptcy status of the transactions. Section __.2 of the Common Rule.

[39] Eligibility depends on the satisfaction of certain liquidity and insolvency related requirements and on the satisfactory completion of a legal review (the contents of which are prescribed in §__.3(b) of the Common Rule).

[40] "The exposure amount of a securitization exposure that is a repo-style transaction, eligible margin loan, or derivative contract (other than a credit derivative) is the exposure amount of the transaction as calculated under §___.34 or §___.37, as applicable." Section __.42(c)(4) of the Common Rule. Section __.34 prescribes the treatment for derivative contracts, and §__.37 prescribes the treatment of collateralized exposures.

[41] This includes derivatives and repo-style transactions that are cleared through a central counterparty and is somewhat broader in scope than its name would suggest. Section __.2 of the Common Rule.

[42] Section __.42(c)(3) of the Common Rule. Special rules apply (i) to guarantees and credit derivatives other than n^{th}-to-default credit derivatives and (ii) to purchased guarantees and credit derivatives. Section __.42(j) of the Common Rule.

[43] Section __.42(c)(3) of the Common Rule.

[44] Section __.42(e) of the Common Rule. There are also special rules for interest-only mortgage-backed securities, small-business loans and leases on personal property transferred with retained contractual exposure, and n^{th}-to-default credit derivatives that are purchased or sold.

determined by applying the general, non-securitization provisions in §§__.36 and __.37 of the Common Rule. The exposure amounts for repo-style transactions, eligible margin loans and derivatives are calculated pursuant to §§__.34 (OTC derivative contracts) or __.37 (collateralized transactions) of the Common Rule, as applicable. Section __.35 of the Common Rule provides the treatment for cleared transactions.

The SSFA is used to calculate risk weights unless the bank chooses to apply the gross-up approach, which it may do if it is not required to calculate its risk-weighted asset amounts under the market risk rule.[45] Roughly speaking, the SSFA adjusts the weighted average total capital requirement of the exposures underlying a securitization exposure to reflect aspects of the creditworthiness of the underlying exposures.[46] This adjusted value is then compared to the values of the attachment and detachment points for each securitization exposure to determine the risk weight for that securitization exposure. If the risk weight as so calculated is less than 20 percent, the minimum risk weight of 20 percent is used instead. If the capital requirement as adjusted for creditworthiness equals or exceeds the detachment point, the securitization exposure is assigned a risk weight of 1250 percent, since such a value implies a total loss at a required capital percentage of eight percent. If the attachment point of a securitization exposure equals or exceeds the creditworthiness-adjusted capital requirement, a special SSFA formula must be used to calculate the required risk weight. Otherwise (i.e., when the attachment point is less than the creditworthiness-adjusted amount and the detachment point exceeds it), the required risk weight is the sum of 1250 percent times a fraction[47] plus 1250 percent times the value of the special SSFA formula times another fraction.[48]

By contrast, the gross-up approach, which if used must with some exceptions be applied to all securitization exposures, computes a credit equivalent amount of a securitization exposure by taking the sum of the exposure amount plus an amount equal to (i) the percentage of the par value of the applicable tranche represented by the bank's exposure times (ii) the par value of the tranches that are senior to the applicable tranche. This credit equivalent amount is then multiplied by the weighted-average risk weight of the exposures underlying the securitization exposure. If the risk weight calculated in this fashion is less than 20 percent, a risk weight of 20 percent must be used instead.[49]

If there are exposures to which a bank applied neither the SSFA nor the gross-up approach, it must assign those exposures a risk weight of 1250 percent, with some exceptions. One of those exceptions permits a bank to compute the risk-weighted asset amount with respect to an eligible ABCP liquidity facility by

45 Section __.43(a)-(d) of the Common Rule.

46 The Basel III Release does not treat as indicative of a lack of creditworthiness deferred interest or principal payments on federal-guaranteed student loans or other consumer loans (including non-federally guaranteed student loans) for which such deferrals are contractually provided and that, in the case of other consumer loans, are not triggered by changes in the borrower's creditworthiness. Section __.43(b)(2)(v) of the Common Rule.

47 The fraction indicates what percentage of the difference between the detachment and the attachment points is represented by the difference between the creditworthiness-adjusted amount and the attachment point.

48 This fraction indicates what percentage of the difference between the detachment and the attachment points is represented by the difference between the detachment point and the creditworthiness-adjusted amount.

49 Section __.43(e) of the Common Rule.

multiplying the exposure amount times the risk weight of the riskiest exposure underlying the securitization exposure.

Advanced Approaches

Just as with the SSFA, an advanced approaches bank must deduct after-tax gains-on-sale resulting from securitizations directly from common equity tier 1 capital, and assign a risk weight of 1250 percent to the portion of a credit-enhancing interest-only strip that does not constitute after-tax gain-on-sale. Once this requirement has been satisfied, a bank must then follow a hierarchy of approaches:

- The supervisory formula approach (SFA), which is set out in §__.143 of the Common Rule, must be applied by a bank that can compute all the parameters required for the application of §__.143 to each securitization exposure that does not require the deduction described immediately above;

- If the bank does not qualify to use the SFA but the other requirements of the preceding bullet point are met, the bank may apply the SSFA;[50]

- If the bank does not qualify to use the SFA and also does not apply the SSFA, it must apply a risk weight of 1250 percent to the exposure; and

- If the securitization exposure is a derivative contract (other than credit protection sold by the bank) that has a first priority claim on the cash flows from the underlying exposures, the bank may apply a special procedure instead of any of those referred to above.[51]

Despite these differences in approach and in parallel to the SSFA, special definitions apply in the advanced approaches to determine the amount of an exposure in general, as well as the specific amounts of the exposures represented by repo-style transactions, eligible margin loans, OTC derivative contracts and cleared transactions. As is the case for the SSFA, generally the carrying value is the exposure value for on-balance sheet securitization exposures, and the notional amount is the exposure value for off-balance sheet securitization exposures. In addition, limitations identical to those in the standardized approach apply to eligible ABCP liquidity facilities. For repo-style transactions, eligible margin loans, OTC derivative contracts (other than credit derivatives) and cleared transactions (again, other than credit derivatives), however, exposure at default is the measurement standard.[52] Advanced approaches banks can recognize the effect of credit risk mitigants pursuant to §__.145 of the Common Rule.

Under the supervisory formula approach, which must be applied if a bank can calculate the various factors used in the associated procedure and formula, the risk-weighted asset amount for securitization exposures of advanced approaches banks is calculated by multiplying the result obtained by applying a procedure and a formula times 12.5. The procedure and the formula take into account more factors than does the SSFA, including, among other things, measures of the number of exposures, the exposure-weighted loss given default, the thickness of a tranche and the value of exposures subordinated to those of the bank.

50 The SSFA is set forth again in §__.144 of the Common Rule.

51 Section __.142(a) of the Common Rule. Special provisions apply if the underlying exposure is not a wholesale, retail, securitization or equity exposure. Section __.142(g) of the Common Rule.

52 Section __.142(e) of the Common Rule.

Consequences

In their general outline and effect, the definitions, rules and procedures described above resemble the analytical and compliance processes that banking organizations already understand. The complexity of these new requirements and the need for their precise and detailed implementation call, however, for a careful evaluation of their effect on all existing and future securitizations, as well as for a review to determine whether any securitization exposures exist that were not previously recognized as such.

For more information, please contact Henry Morriello, George Williams or Karsten Giesecke.

Chicago Office
+1 312 583 2300

Frankfurt Office
+49 69 25494 0

London Office
+44 20 7105 0500

Los Angeles Office
+1 310 788 1000

New York Office
+1 212 836 8000

Palo Alto Office
+1 650 319 4500

Shanghai Office
+86 21 2208 3600

Washington, DC Office
+1 202 682 3500

West Palm Beach Office
+1 561 802 3230