# FINAL MARKET RISK CAPITAL RULE AND SECURITIZATION

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# Overview

- On June 7, 2012, the Board of Governors of the Federal Reserve System ("FRB") released final rules relating to "Risk Capital Guidelines:  Market Risk" to be issued jointly with the Federal Deposit Insurance Corporation ("FDIC") and the Office of the Comptroller of the Currency ("OCC").  The FDIC approved the rule on June 12, 2012 and the OCC will likely approve the rule within the week.

- The Final Rule applies to any "market risk bank" - a banking organization that has trading assets and liabilities of at least $1.0 billion or 10% of its total assets.

- The effective date of the rule is January 1, 2013.

# Background

- The final rule implements the notice of proposed rulemaking with respect to market risk capital rules issued by the agencies on January 11, 2011 (the **"January 2011 NPR"**) and the amendments to that NPR issued by the agencies in December 2011 (the **"December 2011 Amendment"**).

- The January 2011 NPR proposed to implement enhancements to international capital standards for market risk proposed by the Basel Committee on Banking Supervision (**"BCBS"**) other than changes that would have required use of credit ratings.

- In the December 2011 Amendment, the agencies proposed alternative standards of creditworthiness consistent with the requirements of Section 939A of the Dodd-Frank Act.  Under Section 939A, all federal agencies must remove references to, and requirements of reliance on, credit ratings from their regulations and replace them with appropriate alternatives for evaluating creditworthiness.

# Methodology for Securitization Positions

- The Final Rule sets forth methodologies for taking specific risks into account in risk-weighting debt and securitization positions, which the agencies expect will result in capital requirements comparable to those under the Basel standardized measurement method.

- Under the prior rules, if a bank did not model specific risk, it was required calculate a specific risk capital add-on for each securitization position using a standardized method. The standardized method required a bank to multiply the absolute value of the current market value of each net long and net short position in a securitization position by the appropriate specified risk-weighting factor, which range from 0% to 8.0% based on the credit rating and remaining contractual maturity of the position.

- In the Final Rule, the methodology depends on whether the bank uses the advanced capital adequacy framework.

  - A bank that **does not use** the advanced capital adequacy framework must assign a specific risk-weighting factor to a securitization position using either the SSFA set forth in the Final Rule or assign a specific risk-weighting factor of 100% to the position.

  - A bank that **uses** the advanced capital adequacy framework and has a **securitization position that qualifies to use the SFA** <u>must</u> calculate the specific risk add-on for the securitization position using the SFA.

  - A bank that **uses** the advanced capital adequacy framework and has a **securitization position that does not qualify to use the** SFA may assign a specific risk-weighting factor to the securitization position using the SSFA or assign a specific risk-weighting factor of 100%.

# General Requirements to Use SSFA

▪ To use the SSFA to determine the specific risk-weighting factor for a securitization position, the bank must have data that enables it to assign the parameters set forth in the formula.  The data used to assign the parameters must be the most currently available data and must be no more than 91 calendar days old.

▪ If a bank does not have the appropriate data to assign the parameters, it must assign a specific risk-weighting factor of 100% to the position.

**Data Required for SSFA Parameters**

1. Weighted average capital requirement that would be assigned to the underlying exposures under the general risk-based capital rules (Basel I).

2. Delinquency data regarding underlying exposures.

3. Position's level of subordination.

4. Position's relative size within the securitization.

# SSFA Parameters

1. $K_G$ = Weighted average capital requirement of the underlying exposures calculated using the general risk-based capital rules.

2. **Parameter W** = Ratio of (a) the sum of the dollar amounts of the underling exposures within the securitized pool that meet any of the following criteria to (b) the ending balance (measured in dollars) of the underlying exposures:

   (i)  90 days or more past due;

   (ii) subject to a bankruptcy or insolvency proceeding;

   (iii) in the process of foreclosure;

   (iv) held as real estate owned;

   (v) has contractually deferred interest payments for 90 days or more; or

   (vi) is in default.

# SSFA Parameters (continued)

3. **Parameter A** (Attachment Point of Position) = Threshold at which credit losses would first be assigned to the position.

$$\frac{\text{Dollar Amount of Subordinated Positions}}{\text{Dollar Amount of Asset Pool}}$$

4. **Parameter D** (Detachment Point of Position) = Threshold at which credit losses would result in a total loss to the investor in the position.

$$\text{Parameter A} \;+\; \frac{\text{Dollar Amount of Position + Pari Passu Positions}}{\text{Dollar Amount of Asset Pool}}$$

5. Supervisory calibration parameter, **p** = 1.5 for resecuritization positions; 0.5 for other securitization positions.

# Mechanics of the SSFA

The specific risk-weighting factor assigned to a securitization position is the larger of (a) the factor determined in accordance with the Mechanical Rules and (b) a specific risk-weighting factor of 1.6% (equivalent to a 20% minimum risk-weight).

## **Mechanical Rules**

- When Parameter $D \leq K_A$, the specific risk-weighting factor for the position is 100%.

- When Parameter $A \geq K_A$, the specific risk-weighting factor is calculated using the SSFA .

- When Parameter $A < K_A$ <u>and</u> $D > K_A$, the specific risk-weighting factor is the weighted average of 1.0 and $K_{SSFA}$.  For purposes of this calculation:

  (i)   The weight assigned to 1.0 equals $\dfrac{K_A - A}{D - A}$

  (ii)  The weight assigned to $K_{SSFA}$ equals $\dfrac{D - K_A}{D - A}$

  The specific risk-weighting factor will be equal to:

$$SRWF = 100 \times \left[ \frac{(K_A - A)}{(D - A)} \times 1.00 \right] + \left[ \frac{(D - K_A)}{(D - A)} \times K_{SSFA} \right]$$

# SSFA Formula

$$K_{SSFA} = \frac{e^{a \times u} - e^{a \times l}}{a(u-l)}$$

Where  $a = -\dfrac{1}{p \times K_A}$

$u = D - K_A$

$l = A - K_A$

$e = 2.71828$ (base of natural logarithms)

$K_A = (1 - W) \times K_G + (0.5 \times W)$

# Key Changes Reflected in Final Rule

- The Final Rule replaces the proposed flexible floor with an adjustment of $K_G$ based on delinquencies of the underlying assets of the securitization positions.

- SFA is used to calculate capital for trading book positions of advanced approaches banks for which necessary data is available. SFA is mandatory for those banks under these circumstances.

# Lingering Concerns:
# Key Industry Comments Not Reflected in Final Rule

- Setting the minimum risk weight floor at 20% currently creates competitive issues for U.S. banking organizations that seek to purchase high credit quality securitization positions.

- Like the Proposed Rule, the Final Rule ignores the differences in credit quality of exposures of the same broad category underlying a securitization position. Initial $K_G$ for nearly all types of exposures other than qualifying regulated mortgages is 8%.

- The attachment point does not recognize (a) positive differences between the par value and carrying value of a securitization position and (b) cash reserve funds funded from any source.

- The specific risk-weighted factor of the most senior tranche of a securitization should be capped at the adjusted $K_G$.

- Corporate loan securitizations that include a small percentage of assets in the form of other corporate loan-backed ABS should not be treated as re-securitization exposures for purposes of the SSFA calculation. Resecuritization exposure is defined in the Final Rule as a securitization exposure with respect to which <u>any</u> of the underlying exposures is itself a securitization exposure.

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