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Proposed Changes to US Bank Capital Rules: Implications for Securitization Transactions

August 1, 2023

On July 27, 2023, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency issued a joint Notice of Proposed Rulemaking (the "NPR") proposing significant changes to the US bank capital regulations. The NPR proposes several changes to the regulations for determining required capital for bank securitization exposures and additional changes that will impact securitization exposure capital charges. While the proposed changes impact banks originating both traditional and synthetic securitization of their own assets, and securitization exposures in the form of derivatives, and provide a new method for determining the risk weights of exposures to Non-performing Loan ("NPL") securitizations, this Client Alert focuses on the impact of the proposed rules on banks investing in securitization transactions (other than NPL securitizations), both by buying asset-backed securities with the intent to hold such securities[1] and by providing financing of securitizations by making loans or entering into asset purchase facilities, either directly or through credit and liquidity facilities provided to asset-backed commercial paper ("ABCP") conduits.

Comments on the proposal must be submitted by November 30, 2023. The newly proposed rules would be phased in over a three-year period following adoption. The NPR can be found here.

Advanced Approaches Replaced With Expanded Risk-Based Approach — Would Apply to All Banking Organizations With $100 Billion or More of Total Assets

The proposal would replace the internal models-based approach to determine capital in the "advanced approaches" capital rules currently applicable to Category I and Category II banking organizations (see chart below for a description of these Categories) with new so-called risk sensitive standardized requirements (the "expanded risk-based approach") that would apply to all banking organizations with $100 billion or more of total assets (*i.e.,* Category I, II, III and IV banking organizations). In addition, the proposal would subject all of these banking organizations to the supplementary leverage ratio (which, among other things, requires unfunded commitments to be included in the denominator when determining compliance with the required minimum ratio) and to the countercyclical capital buffer, if activated.

Category I	Category II	Category III	Category IV
U.S. GSIBs (and their deposit institution (DI) subsidiaries)	Banking organizations with ≥ $700 billion in total assets or ≥ $75 billion in cross-jurisdictional activity (and their DI subsidiaries)	Banking organizations with ≥ $250 billion in total assets or ≥ $75 billion in nonbank assets, weighted short-term wholesale funding, or off-balance-sheet exposure (and their DI subsidiaries)	Other banking organizations with $100 billion to $250 billion in total assets (and their DI subsidiaries)

Required Capital Is the Higher of the Amount Determined Under the New Expanded Risk-Based Approach and the Current Standardized Approach

The required capital for all banks subject to the expanded risk-based approach would be *the higher of the required capital determined under the new expanded risk-based approach and the required capital determined under the current standardized approach*. No changes are proposed to the current standardized approach for determining the required capital for securitization exposures. This means *required capital for securitizations will still need to be calculated under the standardized approach without the effect of any of the changes proposed to these rules that will be applicable under the new expanded risk-based approach*.

SFA and SSFA Replaced for Purposes of the Expanded Risk-Based Approach With SEC-SA

For purposes of determining required capital for a securitization exposure under the expanded risk-based approach, the proposal would replace the current supervisory formula approach ("SFA") applicable under the advanced approaches and the simplified supervisory formula approach ("SSFA") that will remain applicable under the standardized approach with a modified version of the SSFA called the securitization standardized approach ("SEC-SA"), which would include, relative to the SSFA, modified definitions of attachment point and detachment point, a modified definition of the W parameter, modifications to the definition of K_G, a higher p-factor, a lower risk-weight floor for securitization exposures that are not resecuritization exposures, and a higher risk-weight floor for resecuritization exposures, all as discussed further below. In addition, as also discussed further below, the proposed expanded risk-based approach contains modifications to the risk weights of the exposures underlying securitization exposures for purposes of determining K_G and a new risk weight cap for certain senior securitization exposures. As is the case under the current capital rules relative to the SSFA, if all of the inputs are not available to determine capital using the SEC-SA, the exposure would be assigned a 1,250% risk weight.

Modifications of Definitions of Attachment and Detachment Points

Under the existing capital rules, the attachment point (parameter A) of a securitization exposure is the ratio of the current dollar amount of underlying exposures that are subordinated to the exposure to the current dollar amount of underlying exposures and the detachment point of a securitization exposure (parameter D) is the threshold at which credit losses on the exposure would result in the total loss of principal of the exposure. Any reserve account funded by the accumulated cash flows from the underlying exposures that is subordinated to the banking organization's securitization exposure may be included in the calculation of parameter A to the extent that cash is present in the account. The calculation in the current rules does not permit a banking organization to recognize noncash assets in a reserve account in the calculation of parameter A. The proposal would permit the recognition of all assets, cash or noncash, that are included in a reserve account in the calculation of parameter A under the theory that all of these assets provide credit enhancement to the exposure. However, a banking organization would not be allowed to include interest rate derivative contracts and exchange rate derivative contracts, or the cash collateral accounts related to these instruments, in the calculation of parameters A and D, since none of these instruments provide credit enhancement to the exposure.

The proposal would also modify the definition of parameter A so that it refers to the outstanding balance of the underlying assets in the pool rather than the current dollar value of the underlying exposures. By referencing the outstanding balance of the underlying assets instead of the current dollar amount of the underlying exposures, the revised definition would clarify that nonrefundable purchase price discount may be recognized when calculating the credit enhancement of a securitization exposure. A similar modification would be made to the definition of parameter D.

Modifications of the Definition of Parameter W

Parameter W is the ratio of defaulted exposures underlying a securitization exposure to the outstanding balance of all underlying exposures. The proposal would clarify that for resecuritization exposures, any underlying exposure that is a securitization exposure would only be included in the denominator of the ratio and would be excluded from the numerator of the ratio. Underlying securitization exposures need not be included in the numerator because the risk weight of the underlying securitization exposure already reflects the impact of any delinquent or otherwise nonperforming loans within the underlying securitization exposure.

Modification of Definition of K_G

K_G is the weighted average (based on total principal outstanding) of the total capital of the exposures underlying the securitization exposures. Under the proposal, for interest rate derivative contracts and exchange rate derivative contracts, the positive current exposure times the risk weight of the counterparty multiplied by 0.08 would be included in the numerator of K_G but excluded from the denominator of K_G. If amounts related to interest rate and exchange rate derivative contracts were included in both the numerator and denominator of K_G, these contracts could reduce the capital requirement of securitization exposures even though interest rate and exchange rate derivatives do not provide credit enhancement to the relevant securitization exposure.[2]

Higher Parameter p

Parameter p is a supervisory parameter included in the capital calculation to ensure "appropriately conservative" capital levels for securitization exposures. Under the SSFA, parameter p is 0.5 for securitization exposures that are not resecuritization exposures and 1.5 for resecuritization exposures. Under the proposal, for purposes of calculating capital under the SEC-SA, parameter p would be increased to 1.0 for securitization exposures that are not resecuritization exposures and would remain 1.5 for resecuritization exposures.

Lower Risk Weight Floor for Securitization Exposures That Are Not Resecuritization Exposures

The proposal would apply a risk weight floor of 15% for securitization exposures that are not resecuritization exposures. The current capital rules apply a 20% risk weight floor to these exposures.

Higher Risk Weight Floor for Resecuritization Exposures

For resecuritization exposures, the proposal would require banking organizations to apply a risk-weight floor of 100%. These exposures are subject to the 20% floor under the current rules.

Modified Risk Weights for Underlying Exposures

The proposal would modify the risk weights of several types of underlying exposures that would be used to calculate K_G as compared to the existing standardized approach. While a full discussion of these proposed modifications is beyond the scope of this Client Alert, as examples (i) while all non-defaulted corporate exposures are assigned a 100% risk weight under the standardized approach, under the proposal the risk weight of exposures to investment grade companies with publicly traded securities would be reduced to 65%, (ii) exposures to banks would be assigned three different risk weights based upon whether or not the bank is investment grade and the level of regulatory capital of the bank, and (iii) non-real estate retail exposures would be assigned different risk weights based upon the type and the size of the exposures.

New Risk Weight Cap for Senior Exposures, Including Certain Overlapping ABCP Exposures

The proposal would allow a banking organization to cap the risk weight applied to a senior securitization exposure that is not a resecuritization exposure at the greater of (i) the weighted-average risk weight of the underlying exposures under a new "look-through" approach regardless of the capital determined based on the SEC-SA, and (ii) the 15% risk weight floor. For purposes of calculating the weighted-average risk weight for a senior securitization exposure, the unpaid principal balance would be used as the weight for each exposure. The proposal would define a senior securitization exposure as an exposure that has a first priority claim on the cash flows from the underlying exposures. In determining whether an exposure has a first priority claim on cash flows, banks would not be required to consider amounts due under interest rate derivative contracts, exchange rate derivative contracts, and servicer cash advance facilities, or any fees and other similar payments to be made by the securitization SPE to other parties.

Both the most senior commercial paper issued by an ABCP program and a liquidity facility that supports the ABCP program may be senior securitization exposures under the proposal if the obligation to reimburse the liquidity provider has a first priority claim on cash flows that is senior to all other amounts other than those described above.

For More Information

We would be happy to discuss the aspects of the proposal addressed by this Client Alert or any other aspects of the proposal with you. Please reach out to your usual Chapman attorney contact or Tim Mohan with any questions.

Timothy P. Mohan
Partner
312.845.2966
mohan@chapman.com

1 The NPR also proposes changes to the market risk capital rules that would impact banks buying ABS for their trading books. The potential impact of those changes is also beyond the scope of this Client Alert.

2 A second modification of K_G is proposed with respect to synthetic securitization exposures, discussion of which is beyond the scope of this Client Alert.