U.S. BASEL III STANDARDIZED APPROACH AND ADVANCED AND MARKET RISK APPROACHES NPRs AND SECURITIZATION

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Overview

- On June 12, 2012, the Federal Deposit Insurance Corporation Board of Directors met to consider three notices of proposed rulemaking regarding the standardized approaches rule and the Basel III general and advanced approaches rules. The Board of Governors of the Federal Reserve System proposed these rules at their June 7, 2012 meeting.
- The comment period for the NPRs ends September 7, 2012.

General Takeaways

Implement Dodd-Frank Section 939A and Basel III	• Ratings based approach and internal assessment approach removed from Advanced Approaches rule
All U.S. Banks* must calculate capital using the Standardized Approach	• Becomes the Collins Amendment Floor for advanced approaches banks • Change from Basel II - No ability of other banks to opt to continue to calculate approval under Basel I
SSFA introduced as capital calculation method for banking book exposures	• Advanced approaches banks may use SSFA in determining capital under the advanced approach if can prove do not have data to use SFA • SSFA must be used by market risk banks and advanced approaches banks to determine capital under Standardized Approach • SSFA can be used by other banks to determine capital under the Standardized Approach (if opt into SSFA, must use it for all exposures)
20% risk weight floor for all banking book exposures	SFA, SSFA and Gross-up Approach all impose a 20% RW Floor

*Other than bank holding companies with consolidated assets of $500MM or less.

General Takeaways (continued)

1250% risk-weight now applies to all exposures formerly deducted from capital

- Consistent with Basel III
- Harsher than deduction for banks with risk-based capital ratios exceeding 8%
- Not as harsh as deduction for banks with risk-based capital ratios of less than 8%

Due diligence obligations added

- 1250% risk-weight assigned to securitization exposures as to which required due diligence obligations aren't met
- Banks must demonstrate a comprehensive understanding of each securitization exposure
- Analysis must be updated at least quarterly

General Takeaways (continued)

Disclosure obligations added	• Apply to U.S. banks with $50B or more of total assets • Require quarterly public disclosure of certain qualitative and quantitative information regarding securitizations
Higher capital for resecuritization exposures under SSFA and SFA	• "Resecuritization" defined conservatively as any securitization exposure that is backed by one or more securitization exposures
No relief for banks originating securitizations that cannot achieve sale and de-consolidation under GAAP	• Operational criteria for traditional securitizations include a requirement that the underlying exposures not be consolidated onto the bank's balance sheet for purposes of GAAP

Three Categories of Banks

CATEGORY	DEFINITION	PRESCRIBED APPROACH
Advanced Approaches Banks	<u>Definition Unchanged</u> •Consolidated assets of $250B or more, <u>or</u> •Consolidated on-balance sheet foreign exposures of $10B or more	•Determine capital using Advanced Approach and Market Risk Rules •Determine Collins floor using Standardized Approach
Market Risk Banks (New)	Aggregate total trading assets and trading liabilities equal to; •10% or more of quarter-end total assets, <u>or</u> •$1B or more	•Determine capital using Market Risk Rules for trading book positions •Determine capital using SSFA under Standardized Approach for banking book positions
All Other U.S. Banks*	Not an advanced approaches bank or a market risk bank	•Determine capital using Standardized Approach

*Other than bank holding companies with consolidated assets of $500MM or less.

Change in the Definition of Traditional Securitization – Standardized and Advanced Approaches

- Exclusion for certain investment fund entities provided by new clause (10) in the definition of traditional securitization:

> (10) The transaction is not: (i) an investment fund; (ii) a collective investment fund (as defined in 12 CFR 208.34 (Board), 12 CFR 9.18 (OCC), and 12 CFR 344.3 (FDIC)); (iii) a pension fund regulated under the ERISA or a foreign equivalent thereof; or (iv) regulated under the Investment Company Act of 1940 (15 U.S.C. 80a-1) or a foreign equivalent thereof.

- Exemption provided in response to industry concerns and justified based on the "tightly regulated" nature of these entities and their strict leverage requirements.

Certain Exposures to ABCP Conduits Treated as Resecuritizations

The NPRs incorporate language from the Basel 2.5 proposals that would treat certain exposures to ABCP conduits as resecuritizations. Specifically:

1. Deal-specific liquidity facilities generally are <u>not</u> resecuritization exposures.
2. Program-wide credit enhancement (PWCE) that provides protection across pools above seller protection generally would be a resecuritization exposure.
3. CP would not be a resecuritization exposure if either:
    a. related PWCE is not a resecuritization exposure; or
    b. CP is fully supported by the sponsoring bank.

Standardized Approach – Exposure Amount of Off-Balance Sheet Securitization Exposures

- Generally equals the notional amount of the exposure.
- Notional amount of an eligible ABCP liquidity facility may be reduced to the maximum amount the bank could be required to fund given the program's current assets (without regard to their current credit quality).
- Eligible ABCP liquidity facility cannot fund against assets that are 90 days or more past due or in default.
- The notional amount of an eligible ABCP liquidity facility that is subject to the SSFA would equal the notional amount of the exposure multiplied by a 50% credit conversion factor.

Standardized Approach – Hierarchy of Approaches for Securitization Positions (other than repo-style transactions, mortgage loans and derivatives)

1. Deduct tax gain on sale from common equity and apply a 1250% risk-weight to the portion of a CEIO that doesn't constitute tax gain on sale.
2. Bank may assign a risk-weight using the SSFA. Alternatively, a bank that is not a "market risk bank" may apply the gross up approach. *A bank must apply the SSFA or the gross-up approach consistently across all securitization exposures.*
3. If a securitization exposure does not require deduction under 1 above and a bank cannot or chooses not to apply the SSFA or gross up approach, the bank must apply a 1250% risk-weight to the exposure unless the exposure is an eligible ABCP liquidity facility or an exposure in a second loss or better position to an ABCP conduit.

Hierarchy of Approaches for Securitization Positions – Advanced Approaches Rule (other than derivatives)

1. Deduct tax gain on sale from common equity and apply a 1250% risk-weight to the portion of a CEIO that doesn't constitute tax gain on sale.
2. Bank must assign a risk-weight applying the supervisory formula approach (SFA) if the bank and exposure qualify to use SFA.
3. If the exposure does not qualify for the SFA, the bank may assign a risk-weight to the exposure applying the SSFA. **SSFA may only be used if the bank cannot calculate all of the required SFA parameters and the bank has current data (no more than 91 days old) necessary to determine the SSFA inputs.**
4. Bank must assign a 1250% risk-weight to all other securitization exposures.

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 $A < K_A$ and $D > K_A$, 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 $\frac{K_A - A}{D - A}$

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

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 $a = -\frac{1}{p \times K_A}$

$$u = D - K_A$$

$$l = A - K_A$$

e = 2.71828 (base of natural logarithms)

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

Standardized Approach – Gross-up Approach

- Only available for banks that are not advanced approaches banks or market risk banks.
- Must be applied on a consistent basis for all exposures (can't pick and choose between this approach and SSFA).
- Four inputs must be calculated:
  1. <u>Pro rata share</u> – par value of the bank's exposure as a percent of the tranche that contains the exposure.
  2. <u>Enhanced amount</u> – value of tranches that are more senior to the tranche containing the bank's exposure.
  3. <u>Exposure amount</u> – of the bank's exposure.
  4. <u>Risk-Weight</u> – weighted average risk-weight of the underlying exposures.
- Credit equivalent amount of a securitization exposure equals:

  (exposure amount + pro rata share) x enhanced amount

Standardized Approach – Gross-up Approach (continued)

- Risk-weighted assets under the gross-up approach equal the greater of:

1. Risk-weight of underlying assets x Credit equivalent amount and
2. 20% minimum risk-weight x Exposure amount

Standardized Approach – Eligible ABCP Liquidity Facilities

Banks may determine the risk-weighted asset amount of an eligible ABCP liquidity facility by multiplying the exposure amount by the highest risk-weight of any underlying exposure covered by the facility.

Standardized Approach – Second Loss or Better Exposures to ABCP Programs

- Certain securitization exposures to ABCP programs may apply a risk-weight equal to the greater of 100% and the highest risk-weight of any underlying exposure in the program.
- In order to qualify for this treatment, the following requirements must be met:
  1. Exposure is not an eligible ABCP liquidity facility.
  2. Exposure must be in a second loss or better position and supported by a first loss position that provides "significant credit protection."
  3. Exposure is "investment grade."

     > Investment grade means that the entity to which the bank is exposed through a loan or security, or the reference entity with respect to a credit derivative, has adequate capacity to meet financial commitments for the projected life of the assets or exposure. Such an entity or reference entity has adequate capacity to meet financial commitments if the risk of its default is low and the full and timely repayment of principal and interest is expected.

  4. The bank holding the exposure must not retain or provide protection to the first loss position.

Advanced Approaches – No Significant Changes Made to Supervisory Formula Approach

- The SFA has remained largely unchanged from the Basel II rules, with one significant exception: a 20% risk-weight floor (rather than a 7% risk-weight floor) now applies to all exposures.
- Several issues were raised by the industry with the difficulty of using the SFA where a bank acts as an investor in a securitization rather than the originator that were <u>not</u> addressed, including:
  1. The ability to use a portfolio approach to assigning risk parameters to all securitized asset pools, including wholesale exposures with maturities of greater then one year.
  2. The ability to adjust the credit enhancement (L) and thickness (T) of an exposure based upon its carrying value.
  3. The ability to use cash flow projections to determine available credit enhancement for a securitization exposure.
- Instead, the banking agencies would permit banks that do not have the information necessary to determine the inputs for SFA to use the SSFA to determine capital for the relevant exposures.

Advanced Approaches – Maximum Capital Requirements

- The total risk-based capital requirements for securitization exposures (other than tax gain on sale and CEIO exposures) held by a bank in a single securitization transaction cannot exceed the sum of:
  1. the bank's total risk-based capital requirements for the underlying exposures determined as if the bank directly held such exposures; and
  2. the total expected credit loss (ECL) of the underlying exposures.

Due Diligence Requirements – Standardized and Advanced Approaches

- If a bank is unable to demonstrate to the satisfaction of its primary regulator a comprehensive understanding of the features of a securitization exposure that would materially affect its performance, the bank must assign the securitization exposure a risk weight of 1,250 percent.
- A bank must demonstrate its comprehensive understanding of a securitization exposure by:
  - i. Conducting an analysis of the risk characteristics of the exposure prior to its acquisition, 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 (such as the contractual waterfall, performance triggers, available credit and liquidity enhancement, servicer performance and default definitions);
    - B. Relevant information regarding the performance of the underlying asset pool;
    - C. Relevant market data of the securitization; and
    - D. In addition, for resecuritization exposures, performance information on the underlying securitization exposures.
  - ii. On an on-going basis (no less frequently than quarterly), evaluating, reviewing, and updating as appropriate its due diligence analysis required as described above for each securitization exposure.

Public Disclosure Requirements

- Apply to banks with $50 billion or more in total consolidated assets.
- To be provided quarterly.
- Include specific qualitative and quantitative disclosures regarding a banks securitization exposures and activities, including the roles played by the bank, nature of risks in the securitized assets, risk-based capital approaches applied, and securitization SPEs sponsored.

Effective Dates and Comment Deadline

- The Standardized Approach is effective on January 1, 2015, but a bank may opt to use the approach as of an earlier date.
- The Advanced Approaches NPR does not set forth a proposed implementation date.
- Comment periods for the NPRs expire on September 7, 2012.

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