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Proposed Rules for US Implementation of the Basel II Standardized Approach

A Summary of the Rules Applicable to Securitization Exposures

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PROPOSED RULES FOR US IMPLEMENTATION OF THE BASEL II STANDARDIZED APPROACH:

A Summary of the Rules Applicable to Securitization Exposures

On July 29, 2008, the US federal bank regulators published a notice of proposed rulemaking (the "Proposing Release") relating to proposed rules (the "Proposed Rules") to implement the Basel II standardized approach in the United States.[1] Comments are due October 27, 2008.

In this paper, we summarize the portions of the Proposed Rules that apply to bank[2] securitization exposures, including exposures to both traditional and synthetic securitizations. We focus on the minimum capital requirements—the "first pillar" of Basel II—rather than on either the supervisory review process or market discipline (the second and third pillars), and we do not address the portions of the Proposed Rules relating to capital for operational risks. We also exclude the portion of the Proposed Rules relating to capital for equity exposures, as equity exposures are seldom securitized. Finally, some banks are subject to separate market risk capital rules for positions held in their trading accounts. We do not address positions subject to the market risk rules.

Unless otherwise indicated, section references below refer to sections of the Proposed Rules.

I. Background

The Basel Committee on Banking Supervision consists of senior representatives of bank supervisory authorities and central banks around the world. In 1988, the Committee published an Accord titled *International Convergence of Capital Measurement and Capital Standards*. That Accord formed the basis for the risk-based capital standards adopted by bank regulators in member and many non-member countries. In June 1999, the Committee announced that it was working on a new risk-based capital framework to replace the 1988 Accord. After extensive international consultation, the Committee adopted a new Accord (Basel II) in June 2004.[3]

A. BASEL II

Basel II is meant to be applied "on a consolidated basis to internationally active banks."[4] It provides two broad methods for calculating minimum capital requirements relating to credit risk:

- A "standardized approach," which relies heavily upon external credit assessments by major independent credit rating agencies; and
- An "internal ratings-based approach" (IRB), which permits a bank to use some internal assessments in determining its required capital.

Within Basel II as a whole, a further distinction is made between a "foundation" IRB and a more "advanced" IRB. That distinction does not, however, apply to the securitization framework, where there is a single IRB.

A few years ago, the US federal bank regulators (the "Agencies")[5] tentatively decided that only the advanced IRB would be implemented in the United States, and the Agencies published final rules implementing the advanced IRB (the "US IRB") in December 2007.[6] However, in response to requests from affected banks, the Agencies announced in July 2007 that they would also implement the standardized approach, on an opt-in basis. The standardized approach will take the place of the so-called "Basel IA" rules that were proposed in December 2006.

The US IRB identifies a set of "core banks," which are large or internationally active banks[7] that are required to adopt the US IRB. Other banks will have their choice among three alternatives. They may opt into the standardized approach or (with supervisory approval) the US IRB, or they may remain subject to the currently existing domestic risk-based capital framework (which we refer to below as "Modified Basel I").

The process of opting into the standardized approach under the Proposed Rules is much simpler than the multi-year process for transitioning to the US IRB (whether as a core bank or an opt-in). A bank must notify its primary regulator of its intent to use the standardized approach in writing at least 60 days before the beginning of the calendar quarter in which it first uses the standardized approach, unless its primary regulator consents to a shorter notice. The notice must contain a list of any affiliated banks that do not wish to use the standardized approach.[8] The Proposed Rules also contemplate a procedure for banks to opt

out of the standardized approach after having opted in, though the Agencies indicate that they do not want banks to move back and forth repeatedly.[9]

B. BASIC TERMINOLOGY AND MECHANICS OF THE STANDARDIZED APPROACH

The standardized approach continues to use much of the same fundamental terminology that was used in the original Basel Accord and is still used in Modified Basel I. The mechanics for measuring a bank's actual capital remain essentially unchanged, as does the division of capital between tier 1 capital (which is limited to common stockholder's equity, qualifying noncumulative perpetual preferred stock, including related surplus, and minority interest in equity accounts of consolidated subsidiaries) and tier 2 capital (which encompasses allowances for loan and lease losses, some additional types of preferred stock and related surplus and certain hybrid capital instruments and subordinated debt). Tier 1 capital must make up at least 50 percent of a bank's qualifying capital. For the most part, the Proposed Rules refer to existing (and continuing) US rules on these points and do not change or restate them.

1. Risk Weights

As in Modified Basel I, standardized approach banks will determine risk-based capital requirements for credit risk by multiplying their total risk-weighted assets by a minimum capital requirement (8 percent). The risk-weighted amount of a funded exposure is the product of the amount[10] of the exposure and a "risk weight." For wholesale exposures, the risk weight is generally determined by the external credit ratings of the obligor. For banks, the applicable risk weight is determined by the rating of the nation of incorporation, but notched up one rating category. The risk weight categories for sovereign entities, banks (determined as stated above) and corporate exposures are as follows, using S&P rating designations as examples:

	Risk Weights		
	Sovereign Entities	Banks	Corporates
AAA	0%	20%	20%
AA	0%	20%	20%
A	20%	50%	50%
BBB	50%	100%	100%
BB	100%	100%	100%
B	100%	100%	150%
CCC	150%	150%	150%
No applicable rating	100%	100%	100%

There are also separate risk weights for short-term corporate exposures, based on short-term ratings, and risk weights for public sector entities (based on ratings) and several specific supranational and multilateral institutions. Banks will be required to infer ratings on unrated exposures, based on issuer ratings of the obligor or other externally rated exposures, subject to specified conditions.

Retail exposures are divided into three categories:

- "Regulatory retail exposures,"[11] which will have a risk weight of 75 percent;
- Residential mortgage loans, which will have varying risk weights depending on the loan-to-value ratio; and
- Everything else, which will generally be treated as a corporate exposure and assigned a risk weight of 100 percent.

The rules for determining the risk weight of securitization exposures are discussed in detail in Parts III-V below.

2. Credit Conversion Factors

The standardized approach also retains the concept of "credit conversion factors" as a step in determining the required capital for specified "off-balance sheet" exposures.[12] As under Modified Basel I, specified off-balance sheet exposures are multiplied by a credit conversion factor, and that product (sometimes referred to as a "credit equivalent amount") is multiplied by a risk weight to determine a risk-weighted asset amount.

C. PRINCIPLE OF CONSERVATISM AND RESERVATION OF AUTHORITY

Like the US IRB, the Proposed Rules incorporate a "principle of conservatism."[13] This principle permits standardized approach banks to make simplifying assumptions in their risk-based capital calculations, so long as the simplification increases the capital requirement. A bank is required to provide prior notice to its main regulator before applying the principle and may not apply it to exposures that are, in the aggregate, material to the bank. Also, under all three risk-based capital approaches, the Agencies reserve authority to vary the risk-based capital treatment of exposures based on the economic substance of the exposures or for other safety and soundness reasons.[14]

II. Definition of Securitization Exposures

Because the Proposed Rules treat securitization exposures differently from wholesale or retail exposures, the definition of "securitization exposure" is important. The Proposed Rules handle this definition in substantially the same way as the US IRB. Modified Basel I does not contain a similar definition, but we believe that the regulators would interpret Modified Basel I in a manner generally consistent with these definitions.

The Proposed Rules define "securitization exposure" as "an on-balance sheet or off-balance sheet credit exposure that arises from a traditional or synthetic securitization (including credit-enhancing representations and warranties)."[15] The terms "traditional securitization" and "synthetic securitization" are then defined mostly in terms of the tranching of credit risk. In addition, consistent with the US IRB, the definition of "traditional securitization" expressly excludes transactions where the underlying exposures are owned by (1) an operat-

ing company, (2) a small business investment company and (3) certain other specified entity types. Exceptions (1)-(3) are subject to override by the Agencies, based on a particular transaction's leverage, risk profile or economic substance.

	Synthetic securitization means a transaction in which:	Traditional securitization means a transaction in which:
1	All or a portion of the credit risk of one or more underlying exposures is 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);	All or a portion of the credit risk of one or more underlying exposures is transferred to 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; 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).	

Apart from these exceptions, the definitions of "synthetic securitization" and "traditional securitization" each have four numbered paragraphs, as set out above. Paragraphs (2)-(4) are identical.

Under these definitions, it might appear that investments in many auto lease securitizations would not be treated as securitization exposures, as monetization of lease residuals arguably violates the requirement that "All or substantially all of the underlying exposures are financial exposures." However, the preamble to the Proposed Rules indicates otherwise, stating:

> Based on their cash flow characteristics, for purposes of this proposal, the agencies would also consider asset classes such as lease residuals and entertainment royalties to be financial assets.[16]

On the other hand:

> Mortgage-backed pass-through securities, for example, those guaranteed by Fannie Mae or Freddie Mac, do not meet the proposed definition of securitization exposure because they do not involve a tranching of credit risk.[17]

Interest rate swaps and other non-credit derivatives with a securitization special purpose entity (SPE) as a counterparty are securitization exposures, but the Proposed Rules provide a simplified method to risk weight these exposures in some circumstances.[18]

III. Banks as Investors in Securitization Exposures

Basel II generally treats bank securitization exposures the same, regardless of the capacity in which a bank acquires or retains particular exposures. However, as a practical matter, the portions of the Proposed Rules that are of greatest interest to a bank will depend on whether the bank is acquiring a securitization exposure as an investor, securitizing assets as an originator or taking on exposures in connection with an asset-backed commercial paper conduit. Consequently, in this Part III and the following Parts IV and V, we summarize much of the substance of the Proposed Rules along these lines.

A. RATINGS-BASED APPROACH

If a securitization exposure has a rating from one or more major credit rating agencies, a bank that invests in that exposure will calculate the associated risk-based capital requirement under a ratings-based approach (RBA), similar to the RBA for many wholesale exposures. Because most securitization exposures that banks would acquire as investors are rated, the RBA is the main approach of interest to banks acting as investors. This is consistent with both the US IRB and Modified Basel I, though the actual risk weights, and some other details, vary among the three approaches.

The following table sets out the main features of the RBA under Modified Basel I, the Proposed Rules and the US IRB. The table uses S&P rating categories by way of example, but the rules apply equally to equivalent ratings from the other nationally recognized statistical rating organizations.[19]

For investing banks, one rating is sufficient. If there are multiple ratings on a particular position (including any rating inferred as described below), the lowest rating governs.[20] The credit rating must cover all payments due on the exposure, including both principal and interest if the exposure features both types of payments. Also, the rating must be published in an accessible form and be included in the transition matrices published by the rating agency.[21]

<table>
<tr><th rowspan="3">Long Term Ratings</th><th rowspan="3">Modified Basel I Risk Weights</th><th rowspan="3">Standardized Approach Risk Weights</th><th colspan="3">US IRB Risk Weights</th></tr>
<tr><th colspan="2">Granular Pool</th><th rowspan="2">Non-Granular Pool</th></tr>
<tr><th>Senior Exposure</th><th>Non- Senior Exposure</th></tr>
<tr><td>AAA</td><td rowspan="2">20%</td><td rowspan="2">20%</td><td>7%</td><td>12%</td><td>20%</td></tr>
<tr><td>AA</td><td>8%</td><td>15%</td><td>25%</td></tr>
<tr><td>A+</td><td rowspan="3">50%</td><td rowspan="3">50%</td><td>10%</td><td>18%</td><td rowspan="3">35%</td></tr>
<tr><td>A</td><td>12%</td><td>20%</td></tr>
<tr><td>A-</td><td>20%</td><td>30%</td></tr>
<tr><td>BBB+</td><td rowspan="3">100%</td><td rowspan="3">100%</td><td>35%</td><td colspan="2">50%</td></tr>
<tr><td>BBB</td><td>60%</td><td colspan="2">75%</td></tr>
<tr><td>BBB-</td><td colspan="3">100%</td></tr>
<tr><td>BB+</td><td rowspan="3">200%</td><td rowspan="3">200%</td><td colspan="3">250%</td></tr>
<tr><td>BB</td><td colspan="3">425%</td></tr>
<tr><td>BB-</td><td colspan="3">650%</td></tr>
<tr><td>B, below or unrated[22]</td><td>Gross up</td><td>Deduction</td><td colspan="3">Deduction</td></tr>
<tr><th colspan="6">Short Term Ratings</th></tr>
<tr><td>A-1</td><td>20%</td><td>20%</td><td>7%</td><td>12%</td><td>20%</td></tr>
<tr><td>A-2</td><td>50%</td><td>50%</td><td>12%</td><td>20%</td><td>35%</td></tr>
<tr><td>A-3</td><td>100%</td><td>100%</td><td>60%</td><td>75%</td><td>75%</td></tr>
</table>

While Modified Basel I and the Proposed Rules each specify only a single risk weight for any given rating, the US IRB differentiates within a single rating, depending upon the seniority of the exposure and the granularity of the underlying pool.

B. INFERRED RATINGS

Besides explicitly rated exposures, the RBA is also mandatory for any exposure where a rating can be inferred. An inferred rating must be applied to a securitization exposure when:

(i) The securitization exposure does not have an external rating; and

(ii) Another securitization exposure issued by the same issuer and secured by the same underlying exposures:

- (A) Has an external rating;
- (B) Is subordinated in all respects to the unrated securitization exposure;
- (C) Does not benefit from any credit enhancement that is not available to the securitization exposure with no external rating; and
- (D) Has an effective remaining maturity that is equal to or longer than that of the securitization exposure with no external rating; and

(E) Is the most immediately subordinated exposure to the exposure with no external rating that meets the requirements [above].[23]

The inferred rating that will apply to the unrated exposure in these circumstances is the rating on the reference junior rated exposure.

C. EXCEPTIONS TO RBA

There is an exception to the RBA for interest-only mortgage-backed securities. Regardless of their rating, these securities may never have a risk weight of less than 100 percent.[24] Also, credit-enhancing interest only strips are not subject to the RBA (and must be deducted from capital), regardless of the underlying asset class.[25]

D. FIRST PRIORITY SECURITIZATION EXPOSURES

Banks are generally required to deduct from capital any securitization exposures that are not eligible for the RBA. The Proposed Rules provide three exceptions to this rule, two of which are limited to asset-backed commercial paper (ABCP) conduit exposures and are discussed in Part V.C.2. below. The third exception applies to first priority securitization exposures[26] (excluding eligible ABCP liquidity facilities). Banks are permitted to risk weight such an exposure based on the weighted-average risk weight of the underlying exposures.

While this exception does not provide any risk weight reduction for the first priority position of these exposures, it at least provides a way to avoid deducting them. This seems most likely to be useful to those banks that purchase senior unrated interests in customer receivables directly, without using an ABCP conduit. Under the US IRB, these positions would have to be deducted unless the bank had sufficient information to apply the supervisory formula. Under Modified Basel I, a first priority securitization exposure might be treated the same as under the Proposed Rules, though the rules do not address the point directly.

IV. Banks as Originators

In addition to the specific securitization framework, the more general changes in the risk-based capital framework for retail and wholesale credit exposures under the Proposed Rules are likely to influence the actions of standardized approach banks as originators of securitizations. The OCC and the FRB have long recognized that "one of the motivations behind CLOs and other securitizations is to more closely align the sponsoring institution's regulatory capital requirements with the economic capital required by the market."[27] For banks that move to the standardized approach, that motivating factor may diminish as their risk-based capital requirements move closer to economic capital.

Whether this will alter issuance patterns remains to be seen, but it seems certain that (market conditions permitting) banks will continue to access the securitization markets as originators because of other benefits. For banks that do so, the Proposed Rules include qualitative regulations relating to the process, along with the quantitative risk-based capital calculations.

A. REGULATING THE SECURITIZATION PROCESS

The qualitative regulations for originators include "operational requirements" for traditional and synthetic securitizations generally, as well as rules relating to a number of common features in securitizations. The features that are specifically regulated include clean-up calls, servicer advance facilities, early amortization facilities and representations and warranties. Implicit recourse is also addressed. The operational requirements for synthetic securitizations are discussed in Part VII.A. below.

1. Operational Requirements for Traditional Securitizations

Early in the consultative process for Basel II, one of the consultative documents referred to the operational criteria for traditional securitizations as "requirements for achieving a clean break."[28] That is still their function. Under the Proposed Rules, in order for an originating bank to exclude securitized assets when calculating its risk-based capital requirements, the following "operational requirements" must be satisfied:

- The transfer must be considered a sale under GAAP;
- The bank must have transferred to third parties credit risk associated with the transferred assets;[29] and
- Any clean-up calls associated with the securitization must satisfy the requirements discussed in Part IV.A.2. below.

The same operational requirements apply under the US IRB, and substantially similar requirements apply under Modified Basel I. The regulators have acknowledged that the GAAP sale requirement could become an issue, as the Financial Accounting Standards Board (FASB) is expected to change the applicable accounting standards in the near future.[30] On this point, the Proposing Release states: "if GAAP in this area were to materially change, the agencies would reassess, and possibly revise, the operational standards."[31]

2. Operational Requirements for Clean-Up Calls

One of the operational requirements for both traditional and synthetic securitizations is that any clean-up calls included in the transaction must be "eligible clean-up calls." To be eligible, a clean-up call must:

(i) Be exercisable solely at the discretion of the originating bank or servicer;

(ii) Not be structured to avoid allocating losses to securitization exposures held by investors or otherwise structured to provide credit enhancement to the securitization; and

(iii) (A) For a traditional securitization, be exercisable only 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

(B) For a synthetic securitization, be exercisable only 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.[32]

The Proposing Release contains the following helpful guidance as to the application of the 10 percent limit to master trust issuances:

> Where a securitization SPE is structured as a master trust, a clean-up call with respect to a particular series or tranche issued by the master trust would meet criteria (iii)(A) and (iii)(B) so long as the outstanding principal amount in that series was 10 percent or less of its original amount at the inception of the series.[33]

3. Servicer Advance Facilities

Another common feature in securitizations that is specifically regulated by the Proposed Rules is the servicer advance. The Proposed Rules use the phrase "servicer cash advance facility" to refer to this feature.[34] While these facilities have traditionally been subject to regulatory scrutiny to ensure that they did not serve as credit recourse,[35] Basel II (and the Proposed Rules) focus on a different question: whether the servicer should be required to hold capital against the undrawn portion of any commitment to make advances. The answer is that a bank is not required to hold capital against the undrawn portion of an "eligible servicer cash advance facility,"[36] but is required to calculate capital with respect to any cash advance facility that does not meet the eligibility requirements in the same manner as it would for any other undrawn securitization exposure.[37] In any case, a servicer is required to hold capital against the outstanding amount of any advances.

The eligibility requirements for a servicer cash advance facility are:

(1) The servicer is entitled to full reimbursement of advances, except that a servicer may be obligated to make non-reimbursable advances for a particular underlying exposure if any such advance is contractually limited to an insignificant amount of the outstanding principal balance of that exposure;

(2) The servicer's right to reimbursement is senior in right of payment to all other claims on the cash flows from the underlying exposures of the securitization; and

(3) The servicer has no legal obligation to, and does not, make advances to the securitization if the servicer concludes the advances are unlikely to be repaid.[38]

These requirements are identical to those in the US IRB, but are more stringent than the requirements for "mortgage servicer cash advances" under Modified Basel I.[39] The current requirements for mortgage servicer cash advances parallel requirements (1) and (2) but not requirement (3).

4. Early Amortization Features

Like the US IRB, the Proposed Rules include a new "managed assets" capital charge for revolving credit securitizations that involve early amortization features. This capital charge applies to the portion of the securitized assets that has been transferred to investors in an accounting sale. In effect, this means that the accounting sale is not fully recognized for risk-based capital purposes. The Agencies believe that early amortization features place liquidity and other risks on originating banks that justify additional capital, at least in some circumstances.

The capital charge functions by applying a conversion factor to the portion of underlying receivables that has been sold to investors. That portion is defined as the product of (1) the exposure amount of the underlying receivables and (2) a fraction the numerator of which is the total outstanding amount of securitization exposures and the denominator of which is the outstanding principal amount of the underlying receivables. This product would be multiplied times the weighted average risk weight for the underlying exposures, yielding a risk-weighted asset amount for the investor interests, which would be included in the bank's aggregate risk-weighted assets.

The conversion factor to be used varies depending on the specific terms of the early amortization feature and the nature of the securitized assets. Concerning the terms of the early amortization feature, additional capital will only be required if the trigger for early amortization relates to either the performance of the securitized assets or the originating bank. Also, additional capital will not be required if the early amortization feature leaves investors fully exposed to future draws by obligors on the underlying exposures even after the provision is triggered.[40]

A "controlled" early amortization feature will yield lower capital requirements than an "uncontrolled" one. A controlled early amortization feature is one that meets all of the following conditions:

(1) The originating bank has appropriate policies and procedures to ensure that it has sufficient capital and liquidity available in the event of an early amortization;

(2) Throughout the duration of the securitization (including the early amortization period), there is the same pro rata sharing of interest, principal, expenses, losses, fees, recoveries and other cash flows from the underlying exposures based on the originating bank's and the investors' relative shares of the underlying exposures outstanding measured on a consistent monthly basis;

(3) The amortization period is sufficient for at least 90 percent of the total underlying exposures outstanding at the beginning of the early amortization period to be repaid or recognized as in default; and

(4) The schedule for repayment of investor principal is not more rapid than would be allowed by straight-line amortization over an 18-month period.[41]

Controlled amortization features have generally not been used to date in the US market.

Concerning asset type, securitizations of balances arising under uncommitted revolving retail credit facilities (most notably, credit card receivables) will have a lower conversion factor than securitizations of other revolving credit facilities (either committed or non-retail). Also, the Proposed Rules include an alternative methodology for securitizations of balances under home equity lines of credit (so-called "HELOCs"), which permits banks to apply a fixed conversion factor of 10 percent to the investor interests in securitizations of HELOCs.[42] This special rule for HELOCs does not appear in the US IRB.

For uncommitted revolving retail credit facilities, the Proposed Rules build on the fact that most credit card securitizations require excess spread to be trapped as an additional credit enhancement for investors should the amount of excess spread fall below a specified trapping point. If a transaction does not have this feature, a trapping point of 4.5 percent will be used for the calculation below. The conversion factor is a function of the relationship between the three month average excess spread and the trapping point (or the deemed trapping point of 4.5 percent). The applicable conversion factors, depending upon the nature of the securitized assets and whether or not the early amortization feature is controlled, are set out in the tables below.

Conversion Factors (CF) for Controlled Early Amortization Provisions

	3-month average annualized excess spread	Uncommitted CF	Committed CF
Retail Credit Lines	Greater than or equal to 133.33% of trapping point	0%	90%
	Less than 133.33% to 100% of trapping point	1%	
	Less than 100% to 75% of trapping point	2%	
	Less than 75% to 50% of trapping point	10%	
	Less than 50% to 25% of trapping point	20%	
	Less than 25% of trapping point	40%	
Non- Retail Credit Lines		90%	90%

CF for Non-Controlled Early Amortization Provisions

	3-month average annualized excess spread	Uncommitted CF	Committed CF
Retail Credit Lines	Greater than or equal to 133.33% of trapping point	0%	100%
	Less than 133.33% to 100% of trapping point	5%	
	Less than 100% to 75% of trapping point	15%	
	Less than 75% to 50% of trapping point	50%	
	Less than 50% to 25% of trapping point	100%	
Non- Retail Credit Lines		100%	100%

If a securitization contains a mix of retail and nonretail exposures, or committed and uncommitted exposures, the originating bank may take a pro rata approach to determining the risk-based capital requirement, if feasible. Otherwise, the bank must treat the securitization as a securitization of nonretail exposures, if it includes any nonretail exposures, and as a securitization of committed exposures, if it includes any committed exposures.

5. Credit-Enhancing Representations and Warranties

Consistent with Modified Basel I and the US IRB, the Proposed Rules recognize that one form of recourse relating to securitized assets is a warranty of collectibility, or other representation or warranty, that obligates an originating bank to protect another party from credit losses on the securitized assets. To differentiate representations and warranties of this type from standard representations and warranties designed to ensure that a buyer receives assets consistent with the business understanding, the Proposed Rules define the term "credit-enhancing representations and warranties"[43] and include credit-enhancing representations and warranties in the definition of securitization exposure.[44]

Also consistent with Modified Basel I and the US IRB, the Proposed Rules provide limited carve outs from the definition of "credit-enhancing representations and warranties" for two features that often appear in mortgage securitizations and whole loan sales in the secondary market for mortgages: early default clauses and premium refund clauses. Early default clauses require sellers to repurchase mortgages that default soon after their origination or sale. Premium refund clauses require the return of some or all of the premium (if any) realized by the seller if a mortgage prepays soon after sale. The Proposed Rules provide that the following features are not credit-enhancing representations and warranties:

- Early default clauses and similar warranties that permit the return of, or premium refund clauses that cover, first-lien residential mortgage exposures on one-to-four family residential property for a period not to exceed 120 days from the date of transfer, provided that the date of transfer is within one year of the origination of the residential mortgage exposure; and
- Premium refund clauses that cover underlying exposures guaranteed, in whole or in part, by the US government, a US government agency or a US government-sponsored enterprise, provided that the clauses are for a period not to exceed 120 days from the date of transfer.

6. Implicit Recourse

Consistent with the US IRB, if a bank provides support to a securitization beyond the amount of support required by a pre-existing contractual obligation, then the bank will be required to:

- Hold capital against the underlying exposures as if they had not been securitized;
- Deduct any related gain-on-sale from tier 1 capital; and
- Disclose publicly the fact that it provided implicit support and the regulatory consequences of that action.

The bank's primary supervisor will also have the discretion to require the first two actions described above with respect to the bank's other securitizations.[45]

B. CALCULATING RISK-BASED CAPITAL ON RETAINED INTERESTS

Once a bank, as originator, completes a securitization that satisfies the general operational requirements and any requirements relating to particular transaction features, the next question is how the bank should calculate its risk-based capital on any interests it retained in the securitized assets. Often in securitizations the originator realizes a gain on the sale of the securitized assets, and all or part of the gain results from the retention by the bank (or its bankruptcy remote subsidiary) of a subordinated interest only (IO) strip which represents the rights to excess cash flows from the securitized assets after other securitization exposures have received the cash flows to which they are entitled. These subordinated IO strips are referred to in the Proposed Rules as "credit-enhancing interest-only strips" (CEIOs), and they are subject to special capital requirements. Originators may also retain securitization exposures representing a portion of the principal balances securitized or non-subordinated IO strips. Under a hierarchy of approaches to calculating risk-weighted capital for securitization exposures and some other coordinating rules, the capital treatment of these various retained interests will be as described below.

1. Gain-on-Sale, CEIOs and Other Unrated Exposures

A bank is required to deduct from tier 1 capital any non-cash, after-tax gain-on-sale that results from a securitization and then deduct from total capital the portion of any CEIO that does not constitute gain-on-sale.[46] Originators would also deduct from total capital any other unrated retained positions, unless they qualify for the first priority securitization exposure exception described in Part III. CEIOs and any other amounts required to be deducted from total capital are to be deducted 50 percent from tier 1 capital and 50 percent from tier 2 capital. If the portion to be deducted from tier 2 capital exceeds the bank's tier 2 capital prior to the deduction, then the excess must be deducted from tier 1 capital. A bank may calculate any amount required to be deducted from regulatory capital net of any associated deferred tax liabilities.[47]

2. Rated Exposures

A bank is required to apply the RBA to any retained interests that are externally rated or for which a rating can be inferred (as described in Part III.B. above). Unlike investors, an originating bank must have two external (or inferred) ratings in order to use the RBA. This extra rating requirement for originating banks is identical to the US IRB and similar to Modified Basel I.

3. Maximum Risk-Based Capital Requirement and Overlap Rules

Because originating banks may have multiple retained interests in a single securitization, as well as a capital charge relating to any early amortization feature, there is at least a possibility that the sum of the risk-based capital requirements for these retained interests could

exceed the risk-based capital required for the underlying exposures. The US IRB addresses this possibility by applying a cap to an originating bank's risk-based capital requirements for a particular securitization, which equals the required capital for the underlying exposures (before securitization and including an amount to cover expected credit losses), but any gain-on-sale or CEIO is excluded from this cap.

In contrast, the Proposed Rules provide a cap only for securitizations that have an early amortization feature, and the cap is calculated differently. Under the Proposed Rules, the cap is the higher of (a) the sum of the capital requirements for the retained securitization exposures (which would not include the charge relating to the investors interest) or (b) the capital required for the underlying exposures if they had not been securitized.[49] This is generally consistent with Modified Basel I, where it is possible for a bank's post-securitization capital requirements to exceed the pre-securitization requirement.

The Proposed Rules also avoid duplicative capital requirements for overlapping exposures held by a single bank.[50]

4. Small Business Rule

As required by a federal statute,[51] the current US capital rules include a special set of more lenient rules for the transfer of small business loans and leases with recourse by well-capitalized depository institutions. The Proposed rules generally preserve these more lenient rules,[52] which permit a well capitalized bank that sells small business loan or leases with recourse to hold capital only against the recourse obligation if the transaction qualifies as a sale under GAAP and other specified requirements are met.

V. ABCP Conduit Exposures

A. CONTINUED RELIEF FOR CONDUITS CONSOLIDATED UNDER FIN 46

In 2003, FASB adopted (and revised) *Interpretation No. 46: Consolidation of Certain Variable Interest Entities* (FIN 46). Under FIN 46, many of the banks that sponsored multi-seller ABCP conduits would have been required to consolidate the conduits' assets and liabilities in the sponsoring bank's financial statements. Some sponsors and conduits modified their contractual arrangements so that consolidation was not required, while other sponsors consolidated one or more conduits.

The Agencies did not believe that this GAAP consolidation of conduits, when applicable, would yield appropriate risk-based capital treatment of sponsoring banks' exposures to ABCP conduits. Consequently, the Agencies adopted rules that permitted sponsoring banks to exclude from risk-weighted assets any assets of ABCP conduits that the banks are required to consolidate under FIN 46.[53] Like the US IRB, the Proposed Rules continue this exclusion of consolidated conduit assets from a bank's risk-weighted assets.[54] This is important, as FASB is currently considering more changes to FIN 46, which would make it likely that more ABCP conduits will have to be consolidated in the sponsoring bank's financial statements.[55]

B. PRESERVATION OF THE LIQUIDITY VS. CREDIT ENHANCEMENT DISTINCTION

For most of their history, bank-sponsored ABCP conduits have relied upon a distinction drawn in the first Basel Accord between "commitments" and "direct credit substitutes." Although the operative definitions of these categories, and the details of their risk-based capital treatment, have evolved substantially, commitments have always had a much lower credit conversion factor (zero through September 2005 and 10 percent thereafter for ABCP liquidity commitments with a tenor of one year or less) than direct credit substitutes (at least 100 percent). "Liquidity facilities" provided by banks to conduits can, if properly structured, qualify as commitments and receive this favorable capital treatment. In contrast, credit enhancement facilities are direct credit substitutes.

The key distinction between the two types of facilities is that true liquidity facilities are conditional (they cannot be drawn to cover defaults on the assets owned by the conduit), and credit enhancement facilities are unconditional. For nearly 20 years, the regulatory guidance on this point was relatively informal. Then, in 2004 the Agencies adopted eligibility standards for liquidity facilities to continue to receive favorable capital treatment.[56]

The Proposed Rules also include eligibility standards for ABCP liquidity facilities. Specifically, an eligible ABCP liquidity facility is defined as a liquidity facility supporting ABCP, in form or in substance, that meets the following requirements:

- The facility is subject to an asset quality test at the time of draw that precludes funding against assets that are 90 days or more past due or in default.
- If the assets or exposures that may be funded under the facility are externally rated at the inception of the facility, the facility can be used to fund only those assets or exposures with an applicable external rating of at least investment grade at the time of funding.
- Notwithstanding the two preceding points, a liquidity facility is an eligible ABCP liquidity facility if the assets or exposures funded under the liquidity facility that do not meet the eligibility requirements are guaranteed by a sovereign entity with an issuer rating in one of the three highest investment grade rating categories.[57]

Implementation issues relating to the similar standards under Modified Basel I led the Agencies to release further interagency guidance on the topic.[58] While that guidance is not specifically referenced in the Proposing Release, the Agencies have indicated that they generally expect standard approach banks to continue to use supervisory guidance relating to securitization previously published under Modified Basel I.[59] It would be helpful if the Agencies confirmed that the eligible liquidity guidance is covered by that general statement or revised the eligibility standards to remove the need for the additional guidance.

Under the Proposed Rules, the following credit conversion factors (CCFs) apply to eligible ABCP liquidity facilities:

- 100 percent if the facility qualifies for the RBA (this differs from Modified Basel I, and essentially prevents a bank from getting the benefits of both a favorable ratings-based risk weight and a CCF haircut at the same time);
- 20 percent if the facility has an original maturity of one year or less and does not qualify for the RBA (this compares to a 10 percent CCF under Modified Basel I); and
- 50 percent if the facility has an original maturity of more than one year and does not qualify for the RBA.

These CCFs are applied to the notional amount of the facility (generally the commitment amount), except that banks are permitted to reduce the notional amount 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).[60]

The US IRB makes a major change from this historical approach, in that it does not distinguish between true or eligible liquidity, on one hand, and direct credit substitutes or credit enhancement, on the other, in terms of an applicable CCF or risk weight. Essentially, a 100 percent CCF applies to both liquidity and unfunded credit enhancement facilities, subject to the ability to reduce the notional amount to the maximum potential funding amount (which would usually be relevant only for liquidity facilities). Any difference in the risk-based capital required for these facilities under the US IRB will depend upon other factors.

C. RISK-BASED CAPITAL CALCULATIONS

1. Rated Exposures

Assuming that a bank does not hold any CEIOs or gain-on-sale relating to conduit assets, the first possible method for calculating capital relating to an exposure to a conduit is the RBA. For a bank that sponsors the conduit that benefits from an exposure, the RBA is only available if the sponsor's actual exposure (e.g., a liquidity commitment or credit enhancing letter of credit) has at least two qualifying external ratings, either directly or by inference (as described in Part III above). The two-rating requirement applies because sponsors of conduits fall within the definition of "originating bank."[61] It appears that only one rating would be required if the bank analyzing an exposure (such as a liquidity facility) under the RBA was not the sponsor of the conduit and did not directly or indirectly originate the underlying exposures.[62]

The adopting release for the US IRB provided some interpretive guidance on the application of the internal assessment approach (which is only available under the US IRB and relies on rating agency criteria) to a liquidity facility:

> A commenter asked whether the applicable NRSRO rating criteria must cover all contractual payments owed to the bank holding the exposure, or only contractual principal and interest. For example, liquidity facilities typically obligate the seller to make certain future fee and indemnity

> payments directly to the liquidity bank. These ancillary obligations, however, are not an exposure to the ABCP program and would not normally be covered by NRSRO rating criteria, which focus on the risks of the underlying assets and the exposure's vulnerability to those risks. The agencies agree that such ancillary obligations of the seller need not be covered by the applicable NRSRO rating criteria for an exposure to be eligible for the [internal assessment approach].[63]

Similar issues could arise as to the application of the RBA under the Proposed Rules to liquidity facilities, because an "external rating" under the Proposed Rules must "fully reflect[] the entire amount of credit risk with regard to all payments owed to the holder of the exposure."[64] It would be helpful if the Agencies provided similar guidance in this context.

2. Unrated Exposures

Traditionally, most liquidity and credit enhancement facilities for ABCP conduits have not received external ratings or been senior to positions from which ratings could be inferred. The Proposed Rules are similar to Modified Basel I in their treatment of these unrated exposures, though there is at least one important difference relating to credit enhancement facilities. As to eligible ABCP liquidity facilities, the Proposed Rules permit a bank to apply a risk weight equal to the highest risk weight applicable to any of the underlying exposures covered by the facility.[65]

Credit enhancement facilities would generally fall in the category of securitization exposures in a second loss position or better in an ABCP program. Similar to Modified Basel I, the Proposed Rules appear to permit banks to set capital for exposures in this category based on the bank's own assessment of the credit quality of the exposure. Specifically, if the credit risk of the exposure is the equivalent of investment grade or better (and the exposure derives significant credit protection from first loss positions held by the bank's customer or third parties), then the bank can assign a risk weight equal to the higher of 100 percent or the highest risk weight applicable to any of the underlying exposures.

This is similar to the internal risk rating system for ABCP credit enhancement under Modified Basel I, with the following important difference. Under Modified Basel I, an ABCP credit enhancement facility with credit risk that is one step below investment grade (BB, using S&P's designation system) avoids deduction from capital (or gross up treatment, a largely equivalent concept under Modified Basel I). Under the Proposed Rules, an ABCP credit enhancement facility must be equivalent to investment grade to avoid deduction.

Under Modified Basel I, banks had to receive regulatory approval to use an internal risk rating system on their ABCP credit enhancement facilities. Under the Proposed Rules, no such approval requirement is mentioned; however, when discussing the investment grade equivalency requirement, the Proposing Release seems to indicate that the interagency guidance relating to the Modified Basel I approval process will also apply under the Proposed Rules.[67]

3. Calculation Rules

The Proposed Rules avoid duplicative capital requirements on overlapping exposures held by the same bank and relating to a single conduit. The sum of the commitments under the liquidity and credit enhancement facilities extended to a conduit commonly exceed the maximum amount of commercial paper permitted to be outstanding. When this happens, a bank that has overlapping exposures "is not required to hold duplicative risk-based capital against the overlapping position. Instead, the [bank] may apply to the overlapping position the applicable risk-based capital treatment that results in the highest risk-based capital requirement."[68] This only applies when a single bank has overlapping exposures. If two separate banks have overlapping exposures, each calculates its risk-based capital requirement without reference to the other exposure.

VI. Credit Risk Mitigation

The Proposed Rules also regulate the impact that credit risk mitigation (CRM), in the form of guaranties (or credit derivatives) and collateral, have on the risk-based capital requirement for an exposure.[69] The CRM rules for securitization exposures differ somewhat from the rules for retail and wholesale exposures.

A. SCOPE—WRAPPED DEALS AND THE RBA

The CRM rules do not apply to the historically most common transaction structure in which investors in securitization exposures rely on a guarantee. If a securitization exposure is rated in part based on a surety bond or other guarantee (as would be the case in "wrapped" deals), then a bank will calculate the risk-based capital required for that exposure using the RBA and the actual rating of the transaction.[70] Because the rating depends in part on the wrap, this capital treatment implicitly gives effect to the wrap as CRM without requiring (or permitting) an investor to go through the CRM rules. The flip side of this approach is that a bank cannot double count the CRM by seeking to apply the CRM rules to further reduce the risk-based capital requirement for an exposure of this type. If the CRM is reflected in the rating that drives the RBA capital treatment, the same CRM may not also be used to reduce the capital requirement derived from the RBA.[71]

B. FINANCIAL COLLATERAL

The Proposed Rules treat collateral and guaranties separately. This is important for synthetic securitizations. Although SPEs are not eligible guarantors for CRM purposes, an undertaking by an SPE can be used for CRM if the SPE's obligations are collateralized with recognized collateral. The collateral that will be recognized for CRM purposes is generally limited to "financial collateral," which is defined as cash, gold bullion, conforming residential mortgages and specified types of marketable securities.[72]

Three methods are available to determine the risk-based capital requirement for a securitization exposure that is collateralized with financial collateral:

- A simple approach, in which the risk weight of the collateral (subject to specified floors, for some categories of collateral) is substituted for the risk weight of the exposure for which the collateral is being supplied;
- A collateral haircut approach, which is only available for repo-style transactions, eligible margin loans, collateralized OTC derivative contracts, and single-product netting sets of the foregoing types of transactions; and
- A simple VaR (value at risk) methodology, which requires regulatory approval and is only available for single-product netting sets of repo-style transactions and eligible margin loans.

C. ELIGIBLE GUARANTORS, GUARANTIES AND CREDIT DERIVATIVES

To be eligible as CRM, a guarantee or credit derivative must be issued by an eligible guarantor of a type identified below and must satisfy additional requirements also referenced below. Eligible guarantor is defined to include:

- Sovereign entities, some international organizations, the Federal Home Loan Banks, Farmer Mac, multi-lateral development banks, domestic and foreign banks, bank holding companies and some savings and loan holding companies; and
- Other entities (excluding SPEs) that have unsecured long-term debt ratings without credit enhancement.[73]

For purposes of securitization CRM, the second category is further limited to entities that have a long-term rating in one of the three highest investment grade categories.[74] The additional requirements for guaranties and credit derivatives include some fairly detailed specifications about required contractual terms.[75]

A bank that obtains an eligible credit derivative or other eligible guarantee from an eligible securitization guarantor may adjust the risk-based capital requirement for the covered securitization exposure. To the extent of the notional amount of the derivative or guarantee, the bank may substitute the risk weight of the protection provider for the risk weight of the securitization exposure. To the extent that the protection amount is less than the amount of the securitization exposure, the bank must continue to hold risk-based capital on the uncovered portion of the securitization exposure in an amount proportional to the total risk-based capital requirement for the exposure prior to application of the CRM rules.[76]

The general treatment of CRM in the Proposed Rules requires adjustments to risk-based capital if there is a maturity or currency mismatch between a guarantee or credit derivative and the hedged exposure, or if a credit derivative used as CRM does not include a credit event trigger based on specified types of restructurings of the hedged exposure.[77] The rules for securitization CRM incorporate these requirements.[78]

VII. Synthetic Securitizations

The Proposed Rules generally treat synthetic securitizations like traditional securitizations. Most provisions apply to securitization exposures neutrally, without regard to whether the exposure arises from a traditional or synthetic securitization. However, additional rules apply to synthetic securitizations, in part because of the importance of CRM in synthetic securitizations.

A. OPERATIONAL REQUIREMENTS

The operational requirements for synthetic securitizations are more detailed than those for traditional securitizations. These requirements are generally consistent with the US IRB and are intended to "ensure that the originating bank has truly transferred credit risk of the underlying exposures to one or more third-party protection providers."[79] The requirements, which must be met in order for an originating bank to reduce its risk-based capital, are:

- The credit risk mitigant is financial collateral, an eligible credit derivative, or an eligible guarantee.
- The bank transfers credit risk associated with the underlying exposures to third parties, and the terms and conditions in the credit risk mitigants employed do not include provisions that:
  - » Allow for the termination of the credit protection due to deterioration in the credit quality of the underlying exposures;
  - » Require the bank to alter or replace the underlying exposures to improve the credit quality of the underlying exposures;
  - » Increase the bank's cost of credit protection in response to deterioration in the credit quality of the underlying exposures;
  - » Increase the yield payable to parties other than the bank in response to a deterioration in the credit quality of the underlying exposures; or
  - » Provide for increases in a retained first loss position or credit enhancement provided by the bank after the inception of the securitization.
- The bank obtains a well-reasoned opinion from legal counsel that confirms the enforceability of the credit risk mitigant in all relevant jurisdictions.
- Any clean-up calls relating to the securitization satisfy the requirements discussed in Part II.A.3. above.[80]

Although failure to meet these requirements will prevent the originating bank from reducing its risk-based capital requirements based on a synthetic securitization, the Proposing Release states that a bank that provides credit protection in a synthetic securitization "would use the securitization framework to compute risk-based capital requirements for its exposures to the synthetic securitization even if the originating bank failed to meet one or more of the operational requirements for a synthetic securitization."[81]

B. CALCULATION OF RISK-BASED CAPITAL REQUIREMENTS

Because synthetic securitizations do not result in gain-on-sale or create CEIOs, the first step in the hierarchy applicable to synthetic securitizations is the RBA. As with traditional securitizations, two external or inferred ratings are required for the originating bank to use the RBA, but an investing bank would need only one. Originating banks often retain a "super senior" tranche, with inferred ratings.

Typically, the originating bank in a synthetic securitization obtains credit protection on a mezzanine tranche. The credit protection may take one of two forms: (a) a credit default swap or financial guarantee from another financial institution; or (b) similar protection from an SPE that provides financial collateral for its protection obligations. In situation (a), assuming the protection provider is an eligible securitization guarantor, the originating bank would calculate its risk-based capital requirement as described in Part VI.C. above. In situation (b), the bank would use one of the approaches (most likely the simple approach) described in Part VI.B.

C. NTH TO DEFAULT CREDIT DERIVATIVES

The Proposed Rules provide a simplified method to calculate the risk-based capital effects of a credit derivative that provides credit protection only for the nth reference exposure that defaults in a specified group of reference exposures (an "nth to default credit derivative"). The treatment varies for 1st to default credit derivatives vs. other nth to default credit derivatives. The risk-based capital treatment for banks that obtain or provide credit protection using these derivatives is summarized in the table below.[82]

	1st to default credit derivative	Other nth to default credit derivatives
Protection purchaser	Derivative is treated as covering only the reference exposure with the lowest risk-based capital requirement. Securitization CRM rules are applied to that exposure.	No risk-based capital reduction unless either (a) bank has also obtained credit protection on exposures 1 through (n-1) to default or (b) exposures 1 through (n-1) have already defaulted.
Protection provider	Use RBA if applicable. Otherwise, risk-weighted asset amount equals (a) protection amount of derivative, times (b) the sum of the risk-weights of the underlying exposures, up to a maximum of 1,250%.	Use RBA if applicable. Otherwise, risk -weighted asset amount equals (a) protection amount of derivative, times (b) the sum of the risk-weights of the underlying exposures, up to a maximum of 1,250%.

VIII. Conclusion

The Proposing Release brings securitization market participants an important step closer to a full picture of the risk-based capital standards that will apply to US banks for the foreseeable future. We have attached a table that provides a high-level comparison of the three sets of rules that will apply to various US banks, based on current rules and the Proposing Release. However, as reflected in the Proposing Release,[83] both US and international policy makers have discussed possible modifications in response to the recent credit crisis. Interested market participants should continue to follow these developments closely.

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Summary Comparison of Modified Basel I, the Proposed Rules Implementing the Standardized Approach and the US IRB

This table is meant to facilitate a high-level comparison of the similarities and differences among the three approaches. For brevity, it excludes some details that could be important in particular situations.

	Modified Basel I	Proposed Rules/ Standardized Approach	US IRB
GENERAL PROVISIONS			
Risk-weighting of unsecuritized exposures	Based on broad exposure categories, with a large "kitchen sink" category of 100%	RBA for most wholesale exposures; LTV scale for residential mortgages; 75% for most other retail	Risk adjusted amounts determined by bank inputs (PD, LGD, EAD and, for wholesale, M); calculated for individual wholesale exposures and retail segments
Treatment of unfunded exposures	Defined CCFs are used to convert off-balance sheet exposures to credit equivalent amounts, which are treated like assets and multiplied by the applicable risk weights	Defined CCFs are used to convert off-balance sheet exposures to credit equivalent amounts, which are treated like assets and multiplied by the applicable risk weights	Outside of securitization, banks are required/ permitted to calculate EAD, which takes into account the concept of expected draws prior to default on unfunded exposures. For treatment of unfunded securitization exposures, see ABCP Conduit Exposures below
Definition of securitization	No express definition, but regulators would likely view the definitions from the other two approaches as reflecting policy here also	Express definition, focusing on tranching of credit risk and underlying financial assets; substantially identical to US IRB	Express definition, focusing on tranching of credit risk and underlying financial assets; substantially identical to Proposed Rules
Computational rules	• Although the guidance is not as explicit as in the other two approaches, a single bank is not required to hold duplicative capital if it holds overlapping positions • Securitization can increase a bank's capital requirements compared to holding the underlying exposures	• A single bank is not required to hold duplicative capital if it holds overlapping positions • Securitization can increase a bank's capital requirements compared to holding the underlying exposures, but the special capital charge for early amortization features will not apply to the extent that it would have this effect	• A single bank is not required to hold duplicative capital if it holds overlapping positions • Maximum risk-based capital rule effectively prevents securitization from increasing a bank's capital requirements compared to holding the underlying exposures, but CEIOs and gain-on-sale are excluded from the cap and expected credit losses are added to the cap (since they are not covered by capital for unsecuritized assets)

	Modified Basel I	Proposed Rules/ Standardized Approach	US IRB
TREATMENT OF BANKS AS INVESTORS IN ABS			
Treatment of rated exposures (including inferred ratings)	Risk weights determined by ratings (see table on p. 7); limited ability to infer ratings	Risk weights determined by ratings (see table on p. 7); limited ability to infer ratings	Risk weights determined by ratings (see table on p. 7); limited ability to infer ratings
Treatment of unrated exposures not relating to customer receivables outside of a conduit	The same look through treatment as under Proposed Rules should apply to first priority positions, since they are not direct credit substitutes or recourse; otherwise, subject to gross-up treatment	Look through to risk weights of underlying exposures permitted for first priority positions; positions not in first priority position must be deducted from capital	Must apply supervisory formula (including rules for purchased wholesale receivables, if applicable) or deduct from capital
TREATMENT OF BANKS AS ORIGINATORS IN TRADITIONAL SECURITIZATIONS			
Operational requirements	Though not referred to as "operational requirements," the same requirements specified for the Basel II approaches also apply to Modified Basel I	• GAAP sale • Transfer of credit risk to third parties • Clean-up calls must satisfy eligibility criteria	• GAAP sale • Transfer of credit risk to third parties • Clean-up calls must satisfy eligibility criteria
Servicer advance facilities	Analyzed as possible recourse; no specific discussion of capital for undrawn commitments	Must satisfy eligibility criteria to avoid capital charge for undrawn advance commitment	Must satisfy eligibility criteria to avoid capital charge for undrawn advance commitment
Early amortization features	No special capital charge	• Sliding-scale capital charge based on asset type, deal terms and excess spread triggers • 100% conversion factor for wholesale floor plan • Option of 10% fixed conversion factor for HELOCs	• Sliding-scale capital charge based on asset type, deal terms and excess spread triggers • 100% conversion factor for wholesale floor plan
Credit-enhancing reps and warranties	Treated as recourse or direct credit substitute; safe harbors for early default warranties and premium refund clauses	Treated as a securitization exposure; safe harbors for early default warranties and premium refund clauses	Treated as a securitization exposure; safe harbors for early default warranties and premium refund clauses
Implicit recourse	Specified consequences (loss of low level recourse rule) relating to the affected transaction; broader consequences left to the regulator's discretion	Specified consequences (see p. 13) relating to the affected transaction; broader consequences left to the regulator's discretion	Specified consequences (see p. 13) relating to the affected transaction; broader consequences left to the regulator's discretion

	Modified Basel I	Proposed Rules/ Standardized Approach	US IRB
Gain-on-sale and CEIOs	Banks must deduct from tier 1 capital all CEIOs in excess of 25% of tier 1 capital and maintain dollar for dollar capital against remaining CEIOs.	Banks must deduct any non-cash gain-on-sale resulting from a securitization from tier 1 capital and deduct from total capital and CEIO that does not constitute gain-on-sale.	Banks must deduct any non-cash gain-on-sale resulting from a securitization from tier 1 capital and deduct from total capital and CEIO that does not constitute gain-on-sale.
Other retained unrated exposures	Gross up required, unless rating can be inferred or exposure is in first priority position	Deduct from total capital, unless rating can be inferred or exposure is in first priority position	Apply supervisory formula or deduct from capital, unless rating can be inferred
Retained rated exposures (including inferred ratings)	Apply RBA; two ratings required unless position is "traded"	Apply RBA; two ratings required	Apply RBA; two ratings required
Small business rule	More favorable treatment of recourse than for other transactions; available to well-capitalized banks and subject to other limitations	More favorable treatment of recourse than for other transactions; available to well-capitalized banks and subject to other limitations	More favorable treatment of recourse than for other transactions; available to well-capitalized banks and subject to other limitations
ABCP CONDUIT EXPOSURES			
Treatment of consolidated conduits	Option to exclude assets of consolidated conduits from risk-weighted assets and instead hold capital against bank exposures to conduits	Option to exclude assets of consolidated conduits from risk-weighted assets and instead hold capital against bank exposures to conduits	Option to exclude assets of consolidated conduits from risk-weighted assets and instead hold capital against bank exposures to conduits
Eligibility standards for liquidity?	• No funding against 90+ day assets or rated assets below investment grade • Carve-out for assets with government guaranties • Interpretive relief from first bullet point in some circumstances	• No funding against 90+ day assets or rated assets below investment grade • Carve-out for assets with government guaranties • Possible that interpretive relief from Modified Basel I may also apply here	None

	Modified Basel I	Proposed Rules/ Standardized Approach	US IRB
Treatment of unrated eligible liquidity facilities	• 10% conversion factor if original term is one year or less • 50% conversion factor if original terms exceeds one year • Conversion factors applied to commitment amount • Risk weight based on underlying exposures	• 20% conversion factor if original term is one year or less and not eligible for RBA • 50% conversion factor if original term exceeds one year and not eligible for RBA • 100% conversion factor if eligible for RBA • Conversion factors applied to commitment amount or, if less, maximum amount that could be drawn given current conduit assets • Risk weight based on highest risk weight for any underlying exposure	Assuming bank qualifies for Internal Assessment Approach (IAA): • Liquidity facilities all treated the same, with no eligibility distinction • 100% conversion factor • Conversion factor applied to commitment amount or, if less, maximum amount that could be drawn given current conduit assets • Risk weight determined by IAA (which maps to RBA)
Treatment of unrated ABCP credit enhancement facilities	Based on internal risk ratings (with regulatory approval): • 100% conversion factor if exposure is investment grade • 200% conversion factor if exposure is one category below investment grade • Gross-up if exposure is more than one category below investment grade	Based on internal determination (based on same supervisory guidance as Modified Basel I): • 100% conversion factor if exposure is investment grade • Deduct from capital if exposure is not investment grade	Assuming bank qualifies for IAA: • 100% conversion factor • Conversion factor applied to commitment amount or, if less, maximum amount that could be drawn given current conduit assets • Risk weight determined by IAA (which maps to RBA)
SYNTHETIC SECURITIZATIONS AND CREDIT RISK MITIGATION			
Operational requirements	Although not formally applicable, regulators are likely to look to requirements under Proposed Rules and US IRB	See p. 20	Substantially the same as on p. 20
Recognized protection providers	Banks	Any entity with long-term investment grade rating (not based on credit enhancement)	Any entity with long-term investment grade rating (not based on credit enhancement)
Double default rule?	Not applicable	Not applicable	Not applicable
Recognized collateral	Cash, OECD government securities and GSE securities	Cash, gold bullion, conforming residential mortgages and specified types of marketable securities	Cash, gold bullion, conforming residential mortgages and specified types of marketable securities

Endnotes

1 *Federal Register*, Vol. 73, p. 43982, available at http://occ.treas.gov/fr/fedregister/73fr43982.pdf.

2 In this paper, we use the term "bank" to refer to any depository institution or bank holding company.

3 Available at http://www.bis.org/publ/bcbs128.pdf.

4 Basel II ¶20. Holding companies for internationally active banking groups will also be covered. Basel II ¶21.

5 The Agencies include the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency and the Office of Thrift Supervision.

6 *Federal Register*, Vol. 72, p. 69288 (the "IRB Adopting Release"). A pdf copy is available at http://a257.g.akamaitech.net/7/257/2422/01jan20071800/edocket.access.gpo.gov/2007/pdf/07-5729.pdf. For more information about the US IRB, *see* our client memorandum dated December 10, 2007, which is available at http://www.mayerbrown.com/public_docs/Memo_US_Adoption_BaselII.pdf.

7 Core banks are those with consolidated total assets of $250 billion or more and/or consolidated total on-balance sheet foreign exposure of $10 billion or more. A bank holding company is also a "core bank" if it meets either or both of these tests or if it has any bank subsidiary that is a core bank. If a bank holding company is a core bank, then so are all of its bank subsidiaries (subject to an ability of the principal supervisor to permit some such subsidiaries to opt out of the US IRB in appropriate circumstances).

8 Section 1(c)(1).

9 *See* Section 1(c)(2) and Proposing Release, p. 43986.

10 For funded exposures, the "amount" is: (i) The bank's carrying value minus any unrealized gains and plus any unrealized losses on the exposure, if the exposure is a security classified as available-for-sale; or (ii) The bank's carrying value, if the exposure is not a security classified as available-for-sale. *See* Sections 2 (definition of "exposure amount") and 42(d)(1).

11 For an exposure to qualify as a "regulatory retail exposure," the bank's aggregate exposure to a single obligor must not exceed $1 million, and the exposure must be part of a well-diversified portfolio. Other specifically identified types of exposures (such as equity exposures and securitization exposures) are specifically excluded. Section 2 (definition of regulatory retail exposure).

12 We put the phrase "off-balance sheet" within quotation marks because generally accepted accounting principles (GAAP) have changed since Basel I was adopted, and many of the items referred to as "off-balance sheet" in the rules now sometimes do result in a balance sheet item. However, the formulas used to calculate the balance sheet amount of these exposures under GAAP differ from the formulas used to determine credit equivalent amounts under the risk-based capital rules.

13 Section 1(d).

14 *See, e.g.*, Proposing Release, p. 43986.

15 Section 2.

16 Proposing Release, p. 44008.

17 Proposing Release, p. 44009.

18 Section 42(a)(4).

19 Section 2 (definition of "external rating").

20 Section 2 (definition of "applicable external rating"). This is consistent with the US IRB, except that the US IRB excludes unsolicited ratings.

21 Section 2 (definition of "external rating").

22 Both "gross up" and "deduction" essentially mean that an exposure must be funded entirely with capital and cannot be leveraged.

23 Section 2 (definition of "inferred rating").

24 Section 42(h).

25 Section 42(a)(1).

26 In determining the priority of a securitization claim for this purpose, a bank is not required to consider amounts due under interest rate or currency derivatives, fees due or other similar payments. *See* generally Section 44(b).

27 *Capital Interpretations Synthetic Collateralized Loan Obligations*, OCC BB-99-43, FRB SR 99-32 (November 15, 1999).

28 Consultative Document (January 2001), p. 87.

29 Based on discussion of the parallel requirement in the IRB Adopting Release (p. 69361), we believe that prior guidance provided by the Agencies "to assist banks with assessing the extent to which they have transferred credit risk and, consequently, may recognize any reduction in required regulatory capital" will generally still apply. The prior guidance cited in the IRB Adopting Release is: OCC Bulletin 99-46 (Dec. 14, 1999) (OCC); FDIC Financial Institution Letter 109-99 (Dec. 13, 1999) (FDIC); SR Letter 99-37 (Dec. 13, 1999) (Board); CEO Ltr. 99-119 (Dec. 14, 1999) (OTS). *See also* Proposing Release, p. 44012 (indicating that the Agencies generally expect standard approach banks to continue to use supervisory guidance previously published under Modified Basel I).

30 The status of FASB's deliberations on this topic is summarized at http://fasb.org/project/transfers_of_financial_assets.shtml.

31 Proposing Release, p. 44010.

32 Section 2 (definition of "eligible clean-up call").

33 Proposing Release, p. 44010.

34 Section 2.

35 *See*, *e.g.*, *Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Capital Treatment of Recourse, Direct Credit Substitutes and Residual Interests in Asset Securitizations*, FEDERAL REGISTER, Vol. 66, p. 59614, 59622-23 (2001) (discussing possible treatment of servicer advance obligations as recourse or direct credit substitutes).

36 Section 42(g).

37 Proposing Release, p. 44012.

38 Section 2 (definition of eligible servicer cash advance facility).

39 *E.g.*, Appendix A to 12 CFR Part 208, Part III.B.3.a.x.

40 Section 2 (definition of "early amortization provision").

41 Section 2 (definition of "controlled early amortization feature").

42 Section 46(d)(2).

43 Section 2.

44 Section 2.

45 Section 42(f) and Proposing Release, p. 44012.

46 Rule 42(a)(1). *See also* Section 2 (definition of "gain-on-sale").

47 Rule 42(c).

48 In Modified Basel I, the two-rating requirement applies to "non-traded positions." *See*, *e.g.*, Appendix A to 12 CFR Part 208, Part III.B.3.c.ii.

49 Section 46(a)(2).

50 Section 42(e).

51 12 U.S.C. 1835, which places a cap on the risk-based capital requirement applicable to a well-capitalizeddepository institution that transfers small business loans with recourse.

52 Section 42(i).

53 *Federal Register*, Vo. 68, p. 56530 (2003) (interim final rule); *Federal Register*, Vo. 69, p. 22382 (2004) (extending the effective period of interim final rule); and *Federal Register*, Vo. 69, p. 44908 (2004) (final rule).

54 Section 42(l).

55 The current status of FASB's deliberations on this topic is summarized at http://fasb.org/project/reconsideration_fin46r.shtml.

56 *See* cites in note 53 above.

57 Section 2 (definition of "eligible asset-backed commercial paper (ABCP) liquidity facility").

58 *See* SR Letter 05-13, *Interagency Guidance on the Eligibility of Asset-Backed Commercial Paper Liquidity Facilities and the Resulting Risk-Based Capital Treatment* (undated); and letter, dated March 1, 2007, from the OCC and the FRB to the American Securitization Forum.

59 Proposing Release, p. 44012.

60 Section 42(d)(2).

61 Section 2.

62 Section 2 (definitions of "asset-backed commercial paper (ABCP) program sponsor" and "originating bank").

63 IRB Adopting Release, p. 69365.

64 Section 2 (definition of "external rating").

65 Section 44(a).

66 Section 44(c).

67 Proposing Release, p. 44014, fn. 52.

68 Section 42(e).

69 For a more detailed discussion of credit risk mitigation and synthetic securitizations, see Fontaine, Van Gorp, Hugi and Sabahi, *Synthetic Securitizations Under Basel I and Basel II*, THE REVIEW OF BANKING AND FINANCIAL SERVICES (July 2008), available at http://www.mayerbrown.com/publications/article.asp?id=5185&nid=6.

70 Proposing Release, p. 44014.

71 Section 45(a)(3).

72 Section 2.

73 Section 2 (definition of "eligible guarantor")

74 Section 45(b)(2).

75 Section 2 (definitions of "eligible credit derivative" and "eligible guarantor").

76 Section 36(c).

77 Section 36(d), (e) and (f).

78 Section 45(c).

79 Proposing Release, p. 44010.

80 Section 41(b).

81 Proposing Release, p. 44010. The same is true for investors in traditional securitizations.

82 Section 42(k).

83 *E.g.*, Proposing Release, p. 43985.

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