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SECURITIZATION, FINANCIAL SERVICES REGULATORY & ENFORCEMENT UPDATE

Basel Committee Issues Risk-Based Capital Proposals Responding to Market Crisis

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On January 16, 2009, the Basel Committee on Banking Supervision[1] (the "Committee") proposed amendments to the Basel II Capital Accord responding to the financial markets crisis. The proposed amendments include changes to existing capital requirements for both trading book and banking book exposures. They also include standards to promote more rigorous supervision and risk management, and enhanced disclosure requirements. Comments on the trading book changes are due by March 13, 2009, and the Committee proposes that those changes be implemented in December 2010. Comments on the balance of the changes are due by April 17, 2009, with implementation proposed by the end of 2009 (July 2009 for the risk management changes). Actions of the Committee do not have direct legal effect in the United States (or other participating countries), and implementation of these proposals will require one or more notices of proposed rulemaking, with opportunity for public comment.

We provide some background on the existing risk-based capital rules and summarize the proposed changes below. Except where otherwise noted, our description of the existing rules is based on the versions in effect in the United States.[2]

Trading Book Changes

Background. The Basel capital requirements for trading book exposures have traditionally focused on market price/interest rate risk, as opposed to credit risk (the focus of the banking book capital requirement). The Committee's proposed changes add considerably more emphasis on credit and related risks, but this component of the risk-based capital framework is still referred to as the "market risk rule." The market risk rule imposes a capital requirement that is meant to address both general market risk and "specific risk."

The market risk rule permits banks[3] to address general market risk by calculating a value-at-risk (VaR)-based measure using internal models. As explained by the US bank regulators, "A VaR-based capital requirement is one that is based on an estimate of the maximum amount that the value of one or more positions could decline during a fixed holding period within a stated confidence interval."[4] Currently, the market risk rule requires a 10-day holding period and a confidence interval of 99 percent.

Specific risk is defined as "changes in the market value of a position due to factors other than broad market movements and includes event and default risk as well as idiosyncratic variations."[5] With regulatory approval, banks currently also can use internal models to determine specific risk. Banks that do not have that approval must calculate a specific risk "add-on," using a standard regulatory approach, which calculates the specific risk of each position by multiplying the absolute value of the current market value of each net long or short debt position by a specified risk weighting factor. The risk weighting factor ranges from zero to 8 percent, depending on the identity of the obligor, and in some cases, the credit rating and remaining contractual maturity of the position. For derivatives, the specific risk is based on the market value of the effective notional amount of the position to which the derivative relates. Banks are permitted to net some long and short debt or derivative positions and offset derivatives against the underlying position. Similar rules apply to banks' equity portfolios, using a risk weight of 8 percent (4 percent if the portfolio is both liquid and well-diversified, and 2 percent for certain index funds).

Proposed Changes. The majority of the losses that banks have suffered in the current crisis have occurred in the trading book, and the Committee believes that the current capital framework for market risk fails to capture some key risks. In response, the Committee has proposed significant changes to the market risk capital requirements.[6] To some extent these proposals build on changes the Committee had previously proposed. The most significant proposals are summarized below.

Whether or not a bank has approval to model specific risk, each bank's market risk capital requirement will include an "incremental risk capital charge" (IRCC) similar to the standard specific risk capital charge described above. The IRCC will replace the specific risk capital charge for banks that currently use the standard approach (but not the general market risk VaR measure). Under the IRCC:

- The capital charge for any securitization exposure will be the same capital charge that would apply to that position if held in the banking book. The Committee describes this change as reducing "the incentive for regulatory arbitrage between the banking and trading books."[7]
- The capital charge for other credit products will be required to capture credit migration risk as well as default risk.
- The 4 percent risk weight (which the Committee refers to as a "capital charge") for liquid and well-diversified equity

portfolios will be eliminated, subjecting these portfolios to the standard 8 percent capital charge for equities.

The Committee has also proposed a stressed VaR measure as an add-on to the general market risk capital component. The losses that banks have incurred in their trading books during the financial crisis have significantly exceeded the existing VaR measure (which is based on a 10-day price shock). In response, the stressed VaR will be calculated using a one-year observation period relating to significant losses. The general market risk capital requirement will be the sum of the 10-day shock VaR currently required and this new stressed one-year VaR.

In addition to the changes summarized above, the Committee has proposed several other enhancements to the market risk rules and has indicated that it is undertaking a longer-term, fundamental review of the capital requirements relating to the trading book.[8]

Banking Book Changes

Background. The changes proposed to the banking book rules relate solely to securitization exposures, which are subject to a framework separate from those that apply to retail, wholesale or equity exposures. Under the securitization framework, the capital required for each exposure is generally the product of 8 percent (the minimum capital requirement), the amount of the exposure and a risk weight, which is determined based on external ratings of the exposure (if any).[9] The risk weights applicable to different rating levels vary depending upon whether the bank uses a "standardized approach" (which has been proposed but not yet adopted in the United States)[10] or an "internal ratings-based" (IRB) approach.[11] For some off-balance sheet exposures, a "credit conversion factor" is also used, as discussed below in connection with asset-backed commercial paper (ABCP) liquidity facilities.

In the United States, the IRB is mandatory for "core banks," which are large or internationally active banks.[12] The core banks are currently involved in a multi-year process of transitioning to the IRB. Other banks may have their choice among three alternatives: opting into the standardized approach (if and when adopted); opting into the IRB (which requires supervisory approval); or remaining subject to the currently existing domestic risk-based capital framework (which we refer to below as "Modified Basel I"). Core banks are also currently subject to Modified Basel I and will continue to be subject to capital floors based on Modified Basel I during their transition to the IRB approach.

Banks have to satisfy specified "operational requirements" in order to use the securitization framework, though the existing operational criteria relate primarily to banks acting as originators.

Proposed Changes. The proposed changes[13] affect several aspects of the securitization framework:

- **Risk Weights for Resecuritizations.** The existing risk weight tables for both the standardized and IRB approaches will be revised to provide higher risk weights for resecuritization exposures, defined as securitization exposures where at least one of the underlying exposures is itself a securitization exposure. The revised tables are set out below. The numbers shown in the table are percentages, and the term "deduction" means that a position must be deducted from the bank's capital — essentially it cannot be leveraged.

- **ABCP Liquidity Facilities – Standardized Approach.** ABCP liquidity facilities are treated differently in the standardized and IRB approaches. The standardized approach retains a distinction between eligible and ineligible liquidity facilities that applies in Modified Basel I, with the main criterion for eligibility being a "good asset" test that prevents the liquidity providers from funding assets that are significantly delinquent.

An eligible liquidity facility that is not expressly rated (or otherwise eligible for a ratings-based risk weight)[14] is subject to lower capital requirements than an ineligible liquidity facility of the same size and original maturity (and which also is not eligible for a ratings-based risk weight). The mechanism for reducing the capital requirement is a "credit conversion factor" (CCF), which is applied to the commitment amount before applying a risk weight and the minimum capital percentage. Currently the credit conversion factors are as follows (except for so-called "market disruption" facilities, which are addressed separately below):

» 20 percent if the facility has an original maturity of one year (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.

The Committee has proposed to eliminate the distinction based on original maturity and apply a 50 percent CCF to all eligible liquidity facilities that are not eligible for a ratings-based risk weight.

Standardized Approach

LONG-TERM RATING	SECURITIZATION EXPOSURES	RESECURITIZATION EXPOSURES
AAA to AA-	20	40
A+ to A-	50	100
BBB+ to BBB-	100	225
BB+ to BB-	350	650
B- and below or unrated	Deduction	

SHORT-TERM RATING	SECURITIZATION EXPOSURES	RESECURITIZATION EXPOSURES
A-1/P-1	20	40
A-2/P-2	50	100
A-3/P-3	100	225
All other ratings or unrated	Deduction	

IRB Approach

	SECURITIZATION EXPOSURES			RESECURITIZATION EXPOSURES	
Long-term Rating	**Senior, Granular**	**Non-senior, Granular**	**Non-granular**	**Senior**	**Non-senior**
AAA	7	12	20	20	30
AA	8	15	25	25	40
A+	10	18	35	35	50
A	12	20	35	40	65
A-	20	35	35	60	100
BBB+	35	50	50	100	150
BBB	60	75	75	150	225
BBB-	100	100	100	200	350
BB+	250	250	250	300	500
BB	425	425	425	500	650
BB-	650	650	650	750	850
Below	Deduction				

	SECURITIZATION EXPOSURES			RESECURITIZATION EXPOSURES	
Short-term Rating	**Senior, Granular**	**Non-senior, Granular**	**Non-granular**	**Senior**	**Non-senior**
A1	7	12	20	20	30
A2	12	20	35	40	65
A3	60	75	75	150	225
Below	Deduction				

- **ABCP Liquidity Facilities – IRB Approach.** The IRB approach made a major change from the Modified Basel I approach: it did not distinguish between eligible and ineligible liquidity in terms of an applicable CCF. The capital required for commitments under these facilities is generally the same as for a funded exposure under the same facility in the same amount.[15] A special "internal assessments approach" permits qualifying banks to determine ratings for qualifying unrated liquidity facilities using publicly available rating agency criteria and determine the capital requirement for the facility based on that rating. Because the ratings table under the IRB approach sets different risk weights depending upon the seniority of exposures (if the underlying pool is granular, as defined in the rules), the capital required for a particular liquidity facility will depend, in part, upon whether or not the liquidity facility is treated as a senior exposure. The Committee has proposed additional requirements for when a liquidity facility will be considered senior. The proposed changes are indicated by underlining in the quoted text below.

> Usually a liquidity facility supporting an ABCP programme would not be the most senior position within the programme; the commercial paper, which benefits from the liquidity support, typically would

be the most senior position. However, a liquidity facility may be viewed as covering all losses on the underlying receivables pool that exceed the amount of over-collateralisation/reserves provided by the seller and as being most senior only if it is sized to cover all of the outstanding commercial paper and other senior debt supported by the pool, so that no cash flows from the underlying pool could be transferred to other creditors until any liquidity draws were repaid in full. In such a case, the RBA risk weights in the left-most column can be used. If these conditions are not satisfied, or if for other reasons the liquidity facility constitutes a mezzanine position in economic substance rather than a senior position in the underlying pool, then the "Base risk weights" column is applicable.

The US version of the IRB approach did not use the exact wording from the Basel II Capital Accord, so it is not clear how the language above will be implemented in the United States.

- **General Market Disruption Liquidity Facilities.** Under both the standardized and IRB approaches, as adopted by the Basel Committee, more favorable capital treatment was provided for liquidity facilities that could only be drawn in the event of a general market disruption. The Committee has proposed eliminating this special treatment, which was not adopted in the United States (or proposed as part of the US version of the standardized approach).

- **Operational Requirements for Credit Analysis.** The Committee has proposed additional operational requirements that banks must satisfy in order to use the securitization framework. Unlike the current operational requirements, the new requirements seem to apply to investors, as well as originators. The new criteria require that banks perform their own due diligence on these exposures, as opposed to relying exclusively on external credit ratings. If a bank does not satisfy these requirements, it would be required to deduct the subject exposure from capital.

- **Denying Effect to Self Guaranties.** In response to disruptions in the ABCP market, some banks have purchased ABCP issued by conduits for which the purchasing bank provided liquidity and/or credit enhancement facilities. This led to an issue as to whether a bank could risk weight the purchased ABCP based on the ABCP's ratings, when those ratings depended in part upon the bank's own support and ratings. The Committee has proposed changes to clarify that the answer to that question is no.

Pillar 2 and Pillar 3

Besides establishing minimum quantitative capital requirements (Pillar 1), Basel II also addressed two qualitative matters that the Committee views as important to maintaining adequate capital: the supervisory review process (Pillar 2) and market discipline (Pillar 3), which is facilitated by good disclosure practices. The Committee's proposals also address Pillar 2 and Pillar 3.

The Committee proposes supplemental Pillar 2 guidance to address flaws in risk management practices that were revealed by the financial crisis. The supplemental guidance aims to strengthen the supervisory and risk management processes by clarifying supervisory expectations as to:

- Directors and senior management understanding the risk profile of the bank as a whole;
- Capturing firmwide risk concentrations arising from both on- and off-balance sheet exposures and securitization activities, including the potential impact of non-contractual commitments, implicit support and reputation risk on risk exposures, capital and liquidity; and
- Banks establishing incentives that reflect the long-term risks and rewards associated with their business models.

The supplemental Pillar 2 guidance also incorporates recommendations from other Committee initiatives relating to liquidity risk management, financial instrument fair value practices and stress testing.

As to Pillar 3, the Committee has proposed additional disclosures relating to six topics:

- Securitization exposures in the trading book;
- Sponsorship of off-balance sheet vehicles;
- The internal assessment approach and other ABCP liquidity facilities;
- Resecuritization exposures;
- Valuation methods for securitization exposures; and
- Pipeline and warehousing risks.

Endnotes

1 The Committee consists of senior representatives of bank supervisory authorities and central banks around the world.

2 Each of the FDIC (state depository institutions that do not belong to the Federal Reserve System), the Office of the Comptroller of the Currency (national banks), the Office of Thrift Supervision (nationally chartered thrifts) and the Federal Reserve Board (separately for state member banks and bank holding companies) maintain their own separate versions of the market risk rules, which apply to the banks primarily under their supervision. The agencies coordinate to keep the rules consistent in substance.

3 We use the term "bank" to refer collectively to US insured depository institutions and bank holding companies. In the United States, the market risk portion of the Basel Accords applies only to banks with worldwide, consolidated trading activity equal to at least 10 percent of total assets or $1 billion. The US market risk rules do not yet reflect changes proposed at the international level as part of the Basel II Accord, though they were proposed in the United States in 2006 at FEDERAL REGISTER, Vol. 71, p. 55958 (September 25, 2006). Late in 2007, the agencies indicated that a final rule on that proposal was under development and would be issued in the near future. FEDERAL REGISTER, Vol. 72, p. 69289 (December 7, 2007). Presumably, the financial crisis is at least one reason for the subsequent delay.

4 FEDERAL REGISTER, Vol. 71, p. 55961 (September 25, 2006).

5 *Ibid.*

6 The changes are set out in the Committee's *Revisions to the Basel II market risk framework*, consultative document (January 2009), which is available at http://www.bis.org/publ/bcbs148.pdf?noframes=1. Additional guidance on the incremental risk capital charge is set out in another Committee publication, *Guidelines for computing capital for incremental risk in the trading book*, consultative document (January 2009), available at http://www.bis.org/publ/bcbs149.htm.

7 http://www.bis.org/publ/bcbs148.htm.

8 *Ibid.*

9 Special rules apply to determine risk weights (or otherwise set the capital requirement) for unrated exposures. No changes have been proposed to those rules, so we have not summarized them here. The discussion here also disregards the 1.06 "scaling factor" imposed by the Basel II Capital Accord.

[10] For more information about the standardized approach, as proposed in the US, see our white paper available at http://mayerbrown.com/publications/article.asp?id=5373&nid=6.

[11] For more information about the US IRB, see our client memorandum available at http://www.mayerbrown.com/public_docs/Memo_US_Adoption_BaselII.pdf.

[12] More specifically, "core banks" are banks 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).

[13] The changes to the banking book capital requirements, as well as the Pillar 2 and Pillar 3 changes discussed further below in the text, are set out in the Committee's Proposed enhancements to the Basel II framework, consultative document (January 2009), which is available at http://www.bis.org/publ/bcbs150.pdf?noframes=1.

[14] The exclusion of rated liquidity facilities differs from Modified Basel I, and essentially prevents a bank from getting the benefits of both a favorable ratings-based risk weight and a credit conversion factor reduction to capital on any one facility.

[15] Some complexity is introduced into this comparison by the definition of "amount," but the details are not important for purposes of the change discussed here.

For more information on any matter raised in this Update, please contact the Mayer Brown lawyer with whom you regularly communicate, or one of the following lawyers. To learn more about our Securitization practice, please visit http://www.mayerbrown.com/securitization/overview/index.asp. To learn more about our Financial Services Regulatory & Enforcement practice, please visit http://www.mayerbrown.com/financialservicesregulatoryandenforcement/overview/index.asp.

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