

Basel II Modified in Response to Market Crisis

The Basel Committee on Banking Supervision (the “Basel Committee”) has adopted amendments to the Basel II Capital Accord responding to the financial markets crisis. The amendments largely track proposals made in a set of three consultative documents released in January of 2009. Like the January proposals, the final amendments are set out in three papers (the “Basel Papers”): one dealing with risk-based capital requirements for banking book exposures (the “Banking Book Paper”)¹ and two dealing with the trading book framework.²

Actions of the Basel Committee do not have direct legal effect in participating countries. In the United States, implementation of these changes will require one or more notices of proposed rulemaking with opportunity for public comment. In the European Union, some of the changes have been enacted earlier,³ and implementation of the balance of the changes will require legislative or rulemaking action at the EU level and in EU member states. The European Commission (EC) has already started that process by publishing draft amendments (the “EC Proposal”) to the existing Capital Requirements Directive (the “CRD”).⁴ As they relate to new banking book prudential requirements, the EC Proposal together with the earlier changes (the “CRD Amendments”) are broadly in line with the Basel Papers, although there are some significant differences, as explained below. The CRD is in effect, with some national variations, in EU member states.

We provide some background on the pre-existing risk-based capital rules in the United States and the European Union and summarize the changes below.

Banking Book Background

The changes 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 determined under a “ratings-based approach” (RBA) as 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).⁵ The risk weights applicable to different rating levels vary depending upon whether a bank⁶ uses a “standardized approach” (which has been proposed but not yet adopted in the United States, though it has been adopted in the European Union)⁷ or an “internal ratings-based” (IRB) approach.⁸ 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.

Various special rules apply to determining the required capital for unrated securitization exposures. Under the IRB, the available methods include:

- An internal assessments approach (IAA), which applies only to exposures to ABCP programs and allows qualified banks to assign those exposures to RBA risk-weight categories based on the bank’s own application of publicly available rating agency criteria; and
- A supervisory formula approach (SFA), where banks determine the required capital for securitization exposures by entering data on the exposure and the underlying assets into a formula set out in the rules.

The rules for unrated exposures under the standardized approach are not affected by the changes discussed in this Update, so we have not summarized them here.

In the United States, the IRB is mandatory for “core banks,” which are large or internationally active banks.⁹ 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.

In the European Union, banks may choose the standardized approach or the IRB approach, though the largest and most systemically important banks in the European Union use the IRB approach. Banks continue to be subject to capital floors based on Basel I until the end of 2009.

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 (such as the requirement that originators transfer “significant credit risk” in respect of the securitized exposures). Within the European Union, amendments made to the CRD in May 2009 will extend these operational requirements

to encompass, among other things, the underwriting criteria originators use for exposures to be securitized and disclosure requirements regarding any applicable requirement to retain a portion of the economic risk relating to securitized assets.¹⁰

Resecuritization Changes

Some of the most important changes relate to “resecuritization exposures,” a concept that is new to the Basel II framework and is meant to capture CDOs of ABS¹¹ and other structures with similarly elevated correlation risks. The definition of this concept is important, as some exposures that have structural similarities to CDOs of ABS do not present similar risks. The definition adopted by the Basel Committee reads as follows:

A resecuritisation exposure is a securitisation exposure in which the risk associated with an underlying pool of exposures is tranching and at least one of the underlying exposures is a securitisation exposure. In addition, an exposure to one or more resecuritisation exposures is a resecuritisation exposure.¹²

Risk Weights. The existing RBA risk-weight tables for both the standardized and IRB approaches have been revised to provide higher risk weights for resecuritization exposures. 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.

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

Long-term Rating	SECURITIZATION EXPOSURES			RESECURITIZATION EXPOSURES	
	Senior, Granular	Non-senior, Granular	Non-granular	Senior ¹³	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				

Short-term Rating	SECURITIZATION EXPOSURES			RESECURITIZATION EXPOSURES	
	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				

The RBA risk weights for resecuritization exposures would apply equally under the IAA. To maintain consistency between the RBA and the SFA, the SFA floor risk weight is set at 20 percent for resecuritization exposures. As a result, senior resecuritization exposures cannot achieve a risk weight under the SFA that is lower than the lowest RBA risk weight for resecuritization exposures (20 percent).

The EC Proposal adopts the same risk-weightings tables and rules. It also provides that, in applying the Supervisory Formula to a resecuritization position, the effective number of exposures (which determines whether or not a pool is “granular”) is “the number of securitisation exposures in the pool and not the number of underlying exposures in the original pools from which the underlying securitisation exposures stem.”¹⁴

Innocent Bystanders. The risk weights for resecuritization exposures shown above are the same as the Basel Committee proposed in January, but the final definition (as quoted above) varies somewhat from the original proposal (which defined resecuritization exposures simply as securitization

exposures where at least one of the underlying exposures is itself a securitization exposure). The revised, final definition emphasizes that there must be at least two layers of credit tranching for an exposure to be a resecuritization exposure. It also clarifies that an exposure to a single underlying exposure will not be a resecuritization exposure unless the underlying exposure is already a resecuritization exposure.

The definition originally proposed raises issues as to whether some “innocent bystander” exposures, with a superficial resemblance to CDOs of ABS, might be treated as resecuritization exposures even if they did not present similar risks. The revised definition helps with some of the innocent bystanders, as does some explanatory text that accompanies the definition in the Banking Book Paper. Unfortunately, the EC Proposal does not use the Basel Committee’s final definition of resecuritization exposure, nor does it include the helpful explanatory text. As discussed below, this raises questions on the treatment of the “innocent bystanders” and whether the rules on resecuritization will be different in EU member states than in the United States and other countries.

ABCP Exposures. The Banking Book Paper provides detailed (though not exhaustive) guidance as to what exposures to an ABCP program are and are not to be treated as resecuritization exposures. The guidance is more favorable to the market than the January proposal, though market participants did not convince the regulators on every point. The guidance is framed in the context of a “traditional multi-seller ABCP conduit that acquires senior securitisation exposures in separate pools of whole loans where none of these loans is a securitisation or resecuritisation exposure, and where the first-loss protection for each conduit investment is provided by the seller.”¹⁵

In this context, the Banking Book Paper indicates that:

- A pool-specific liquidity facility (meaning a facility where draws are tied to, and reimbursed from, just one of the conduit’s pools) generally would not be a resecuritization exposure because it represents a tranche of a single pool of whole loans, which contains no securitization or resecuritization exposures;
- A program-wide credit enhancement (PWCE) facility sized at only some percentage (e.g., 5-10 percent) of the outstanding ABCP (a traditional partially supported facility) would be a resecuritization exposure because it constitutes a risk tranche on a pool of multiple assets that contains at least one securitization exposure; and
- The ABCP generally itself might or might not be a resecuritization exposure. Assuming there is only one class of ABCP (no credit tranching within the ABCP itself), that ABCP will not be a resecuritization exposure if the program satisfies at least one of the following conditions:
 - » the PWCE is not itself a resecuritization exposure under the test described above (which seems to mean that the stated amount of the PWCE would have to equal or exceed the amount of outstanding ABCP); or
 - » the ABCP is “fully supported by the sponsoring bank (i.e., where the sponsor provides support to an extent that leaves the CP effectively exposed to the default risk of the sponsor, instead of the underlying pools or assets) so that the external rating of the CP was based primarily on the credit quality of the bank sponsor.”¹⁶

The second option above (“fully supported by the sponsoring bank”) is unclear on a couple of points that will have to be resolved in the national adoption process or interpretation. First, it is not clear whether “fully supported” has the traditional market meaning (essentially unconditional support for 100 percent of outstanding ABCP) or instead might be satisfied by traditional “true liquidity” or “eligible liquidity” facilities that cover 100 percent of the outstanding ABCP. Many market participants believe that the final clause (“the external rating of the CP was based primarily on the credit quality of the bank sponsor”) is satisfied as to programs with 100 percent true liquidity coverage.

Also, the second option refers to full support specifically by the sponsoring bank. While this may not be a significant practical issue given the limited syndication of liquidity in recent years, it is hard to see why “full support” from multiple banks would not also work. It may be that this was meant as a simple example. We believe there is at least room for argument that “full support” from multiple banks would also work (so long as the banks were not in tranching positions).

The Banking Book Paper does not specifically discuss so-called “general liquidity” facilities, which generally are not pool-specific but cover only 10-20 percent of outstanding ABCP. These facilities might be viewed as a credit tranche, and it has been suggested that banks consider structuring them as “eligible servicer cash advance facilities,” which qualify for a zero percent conversion factor under Basel II.

Credit Card and Auto Lease Structures. Some market participants were also concerned that the definition of resecuritization exposure, as originally proposed, might be viewed as encompassing credit card issuance trusts or auto lease titling trust structures. In both of these structures, the receivables backing one or more series of securities are held by one trust (sometimes more than one, in the case of credit card receivables), and securities are issued to investors by a second trust (an “issuing trust”) that holds beneficial interests in the first trust (or trusts). These multiple-trust structures were devised for various legal and other reasons. In each case, however, the economic experience of holders of the securities issued in these structures is

substantially identical to what it would be if the issuing trusts held the underlying receivables directly.

Fortunately, under the final Basel language, it seems more clear that securities issued out of these structures should not be viewed as resecuritization exposures, especially if all of the receivables are held in a single trust. In that case, there is only one underlying exposure, so the securities are not “securitization exposure[s] in which the risk associated with an underlying pool of exposures is tranced,”¹⁷ since a single underlying exposure does not constitute a “pool.” Consequently, these securities should not be treated as resecuritization exposures unless the single underlying exposure is itself a resecuritization exposure (which is not customary).

Repackaging of Single Securities. There has been significant activity lately in repackaging ABS that have been downgraded due to increased delinquencies and defaults on the underlying assets. The idea behind these transactions is that some significant portion of the par balance of the ABS can still achieve the original credit ratings, if additional credit enhancement is provided. The additional credit enhancement takes the form of one or more classes of subordinated securities representing the difference between the par amount of the ABS and the senior tranche (which achieves the original ratings). Under the definition of resecuritization exposures that was originally proposed, it appeared that these repackagings would be resecuritizations, because they issue securitization exposures and the underlying asset (the ABS) is also a securitization exposure. However, under the final Banking Book Paper definition, these repackagings should not be treated as resecuritizations so long as there is only one underlying exposure that is not itself a resecuritization exposure.

In the context of ABS (which, like any fixed income securities, are typically divisible into \$1,000 par units), it would seem that the single-underlying-exposure test should be met whenever the underlying exposure represents a single class of a single securitization (where none of the underlying exposures are themselves resecuritizations). This fits the purpose of the new resecuritization provisions, because there is no risk of heightened default correlations if there is only one

underlying pool of whole loans. A similar argument could be made for proportionate shares of two or more contiguous tranches.

Resecuritization in the EU Proposal. The EC Proposal, like the Basel Committee’s and the EC’s earlier consultation papers on this subject, defines a “resecuritisation” as “a securitisation where one or more of the underlying exposures meet the definition of a securitisation position.”¹⁸ The EC Proposal also does not include, or refer to, the explanatory material about the definition of resecuritization that appears in the Banking Book Paper. The EC Proposal thus fails to address the concerns about the scope of the definition that were raised during the consultation period, in particular the “innocent bystander” issues discussed above.

As a result, under the EC Proposal, it is not yet clear whether or not exposure to a single transaction under an ABCP liquidity facility, to an ABS issued in a double-trust structure, or to a repackaging of a single ABS, would be treated as a resecuritization. ABCP may be treated as a resecuritization exposure even if “fully supported” by its sponsoring bank or group of liquidity banks. That is, similar investments could be treated differently (and much less favorably) if made by European credit institutions rather than by US or other non-European institutions.

In its impact assessment accompanying the EC Proposal, the European Commission described various legislative options and recognized that “the broad definition of resecuritization may capture instruments such as asset backed commercial paper whose risk characteristics are very different from CDOs of RMBS. However, in many cases and for purely technical reasons, these conduits may in many instances still meet the definition of a resecuritisation.”¹⁹ Though the European Commission identified this problem during the consultation, the EC Proposal takes no account of it.

The EC Proposal refers to its provisions for higher capital requirements for resecuritization provisions as “[i]n line with the approach developed by the Basel Committee.”²⁰ Before the EC Proposal is approved by the European Parliament and the Council of Ministers, it should be amended to make clear that

the scope of the definition of resecuritization in the European Union will be the same as it was under the amended Basel II Capital Accord. Failing this, national legislators or regulators should clarify the scope when the changes are implemented at a national level.

The EC Proposal also introduces a concept of “highly complex resecuritizations,” a category to be defined by the Committee of European Banking Supervisors (CEBS).²¹ As to this category of exposures, credit institutions must apply a 1,250 percent risk weight (that is, in effect, deduct them from capital) unless the credit institution can demonstrate compliance with the operational requirements for securitization exposures.²² This is another way in which the EC Proposal differs significantly from the Banking Book Paper, which does not employ the concept of “highly complex resecuritizations.”

The EC’s earlier consultation paper on resecuritization proposed that all resecuritization exposures be deducted from capital unless the operational requirements were met — but the European Commission was of the view that, due to the complexity of resecuritizations, the required level of due diligence could not be met in practice.²³ Accordingly, during the consultation period, there was concern that EU regulators would treat the vast majority of resecuritizations as attracting the punitive 1,250 percent risk-weight. The resulting EC Proposal, in which deduction from capital would only apply “in exceptional cases,”²⁴ is therefore milder in application than the earlier proposed approach and is more nuanced than the Banking Book Paper, since it suggests a higher standard of investor diligence would be required for highly complex resecuritizations.

Other Banking Book Changes

The Basel Committee has made several other important changes to the banking book securitization framework:

- **Denying Effect to Self Guaranties.** In response to disruptions in the ABCP market, some banks purchased ABCP issued by conduits for which the purchasing bank provided liquidity and/or credit enhancement facilities. This led to the question of 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 Basel Committee has

adopted changes to clarify that the answer to that question is “no.” Some market participants have been uncertain as to what risk weights should be applied in this situation. We believe there is a good argument that IAA banks should be able to apply the IAA to this ABCP, and we hope that the US regulators will provide additional clarity in the version of these changes that they ultimately adopt. Standardized banks should generally be able to apply the look-through provisions in Section 573 or 576 of Basel II.

The EC Proposal follows the Banking Book Paper in clarifying the inapplicability of self-guarantees. It also makes explicit that, where exposure to an ABCP conduit by way of commercial paper overlaps with exposure by way of a liquidity facility, the risk-weighting associated with the liquidity facility may be used to calculate the risk-weighted capital requirement.

- **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)²⁵ 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. Originally, the credit conversion factors were 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 Basel Committee has eliminated the distinction based on original maturity and now applies a 50 percent CCF to all eligible liquidity facilities that are not eligible for a ratings-based risk weight.²⁶ The European Commission has already approved this change in the CRD amendments adopted in May 2009.²⁷

- **ABCP Liquidity Facilities–IRB Approach.**

The IRB approach made a major change to 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 and would generally be determined by applying a ratings-based risk weight under the IAA.²⁸ 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 Basel Committee has adopted additional requirements for when a liquidity facility will be considered senior. The 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.

Neither the US version of the IRB approach nor the EU CRD used the exact wording from the Basel II Capital Accord, so it is not clear how the language above will be implemented. The EC Proposal does not address this point.

- **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 Basel Committee has eliminated this special treatment, which was not adopted in the United States (or proposed as part of the US version of the standardized approach). The European Union approved a corresponding amendment to the CRD earlier this year.

- **Operational Requirements for Credit Analysis.**

The Basel Committee has adopted additional operational requirements that banks must satisfy in order to use the securitization framework. Unlike the original operational requirements, the new requirements 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.

In this respect, from the point of view of investors, the EU CRD is a step ahead of the Basel II Capital Accord. Following its May 2009 amendment, the CRD will include a new Article²⁹ dealing with due diligence and operational requirements such as monitoring performance of all securitizations (not just resecuritizations). These new provisions of the CRD, in large part, are now reproduced (in places, verbatim) in the Banking Book Paper. However there is one significant difference. Whereas the new Basel II criteria demand a deduction if these

operational requirements are not met in respect of securitizations, the CRD will impose a variable additional risk weight of not less than 250 percent (capped at 1,250 percent) on the infringing bank investor, intended to be proportionate to the extent of the non-compliance.

Pillar 2 and Pillar 3

Besides establishing minimum quantitative capital requirements (Pillar 1), Basel II also addressed two qualitative matters that the Basel 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 Banking Book Paper also addresses these qualitative Pillars.

Under Pillar 2, the Banking Book Paper provides supplemental guidance to address weaknesses in risk management practices that were revealed by the financial crisis. The supplemental guidance includes clarified 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 Basel Committee initiatives relating to liquidity risk management, financial instrument fair value practices and stress testing.

The EC Proposal does not have the same provisions relating to risk management practices as the Banking Book Paper, mainly because these were addressed in the May 2009 amendments to Annex V of the CRD. However, the EC Proposal contains more detailed provisions to govern banks' remuneration policies, a topic of intense political and media debate over the last year. The thrust of these provisions is to align the "remuneration of staff whose professional activities

have a material impact on their risk profile" with the promotion of "sound and effective risk-management [which] does not exceed the level of tolerated risk of the credit institution." Notably, this includes requiring that "the major part of a significant bonus" is "deferred for an appropriate period and is linked to the future performance of the firm." The Banking Book Paper section on remuneration is rather more "high level" in its approach, setting out general objectives for ensuring remuneration is aligned with the firm's risk profile and performance.

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

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

At the EU level, the EC Proposal will enhance the existing disclosure requirements set out in the CRD. These enhancements are broadly in line with the Banking Book Paper.

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 Basel Committee's changes emphasize 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 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."³⁰ 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.”³¹ With regulatory approval, banks can currently also 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).

Changes. The majority of the losses that banks have suffered in the current crisis have occurred in the trading book, and the Basel Committee believes that the current capital framework for market risk fails to capture some key risks. In response, the Basel Committee has made significant changes to the market risk capital requirements. The most significant changes 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, except that a different measure will apply to correlation trading portfolios (a new term added to the market risk framework by these changes). The Basel

Committee describes this change as reducing “the incentive for regulatory arbitrage between the banking and trading books.”³²

- 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 Basel 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 Basel Committee also now requires 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.

The EC Proposal amendments to the trading book are “aligned with what is envisaged by the Basel Committee.”³³ The EC Proposal therefore seeks to amend the treatment of the trading book under the CRD to:

- Align the capital that banks are required to hold in respect of trading book positions in securitizations with the capital that they would hold for the same positions if held in the banking book, by introducing a separate standardized capital charge for securitization positions;
- Require banks to estimate potential losses during protracted stressed conditions; and
- Capture losses from credit quality deterioration (i.e., adverse credit migration) by requiring banks to capture incremental risks at the 99.9 percent confidence interval over a one-year horizon.

The EC Proposal also follows the amended Basel II rules in replacing the 4 percent multiple for calculating the bank’s credit requirement for specific risk in respect of equity portfolios with an 8 percent multiple.

Endnotes

- ¹ *Enhancements to the Basel II framework* (July 2009), which is available at <http://www.bis.org/publ/bcbs157.pdf?noframes=1>.
- ² *Revisions to the Basel II market risk framework* (July 2009) (the “Market Risk Paper”), which is available at <http://www.bis.org/publ/bcbs158.pdf?noframes=1>, and *Guidelines for computing capital for incremental risk in the trading book* (July 2009), available at <http://www.bis.org/publ/bcbs159.pdf?noframes=1>. 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.
- ³ Two legislative measures are intended to achieve this at the EU level: a “Co-Decision” measure and a “Comitology” measure; these are, respectively, available at <http://register.consilium.europa.eu/pdf/en/09/st03/st03670.en09.pdf> and http://ec.europa.eu/internal_market/bank/docs/regcapital/2006_48_comitology_en.pdf. Both await publication in the Official Journal of the European Union, so technically they are not yet law.
- ⁴ The EC Proposal is available at http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/Leg_Proposal_Adopted_1307.pdf. The CRD sets out the capital requirements for banks and other credit institutions within the EU.
- ⁵ The discussion here disregards the 1.06 “scaling factor” imposed by the Basel II Capital Accord.
- ⁶ In our discussion of the United States, we use the term “bank” to refer collectively to US insured depository institutions and bank holding companies.
- ⁷ 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>.
- ⁸ For more information about the US IRB, see our client memorandum available at http://www.mayerbrown.com/public_docs/Memo_US_Adoption_BaselII.pdf.
- ⁹ 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).
- ¹⁰ CRD Article 122a(5).
- ¹¹ CDO stands for collateralized debt obligation. ABS stands for asset backed securities.
- ¹² Paragraph 541(i) of Basel II, as added by the Banking Book Paper.
- ¹³ Senior resecuritization exposures are defined as resecuritization exposure satisfying the following two conditions: (a) the exposure is a senior position, and (b) none of the underlying exposures are themselves resecuritization exposures.
- ¹⁴ EC Proposal, Annex I, paragraph (3)(xii), amending Directive 2006/48/EC, Annex IX, point 53.
- ¹⁵ Banking Book Paper, p. 2.
- ¹⁶ *Ibid.*
- ¹⁷ The quoted language is part of the Basel Committee’s final definition of resecuritization exposure, as quoted above.
- ¹⁸ EC Proposal, Article 1, paragraph (1), amending Directive 2006/48/EC Article 4.
- ¹⁹ EC Impact Assessment, which is available at http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/impact_assesment_en.pdf
- ²⁰ EC Proposal, Explanatory Memorandum, part 3 (Impact Assessment).
- ²¹ EC Proposal, preamble paragraph (16).
- ²² EC Proposal, Article 1, paragraph 9, amending Directive 2006/48/EC by adding new Article 122a.
- ²³ EC Consultation Paper, p.2. The EC Consultation Paper is available at http://ec.europa.eu/internal_market/bank/docs/regcapital/consultbesec_en.pdf
- ²⁴ EC Proposal, Explanatory Memorandum, part 5.1 (Detailed explanation of the proposal – Capital requirements for re-securitization).
- ²⁵ 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.
- ²⁶ The Committee has made a similar change to paragraph 639 of Basel II, which permits IRB banks to apply a CCF to liquidity facilities in certain exceptional circumstances (but the CCF in that section is now 100 percent, regardless of maturity). The U.S. did not include paragraph 639 in its version of the IRB.
- ²⁷ The relevant amendments may be found at page 11 of the CRD comitology amendment text (see note 4)
- ²⁸ 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.
- ²⁹ Article 122a(4) and (5)
- ³⁰ FEDERAL REGISTER, Vol. 71, p. 55961 (September 25, 2006).
- ³¹ *Ibid.*

³² Market Risk Paper, p. 1.

³³ EC Proposal, Explanatory Memorandum, part 3 (Impact Assessment) (Trading Book).

For more information about 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>.

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