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Legal Update
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Securitization Provisions Contained in Final Rule to Implement Basel III Regulatory Capital Framework in the United States

Each of the US bank regulators[1] (collectively, the Agencies) has recently adopted a final rule[2] (in the case of the FDIC, an interim final rule) to implement the Basel III regulatory capital framework[3] for banking organizations in the United States.[4] This update will describe the Final Rule's securitization provisions in more detail since, while arguably containing no significant surprises (at least to those familiar with the June 2012 NPRs and US Basel II), the securitization provisions of the Final Rule are nevertheless likely to cause some disappointment to affected banking organizations insofar as many objections and requests for relief were not reflected in the Final Rule. Moreover, the Final Rule reflects the recognition that the securitization framework is something of a "work-in-process" with ongoing BCBS work-streams and other activities that could – even significantly - impact the securitization framework, as well as the Agencies' ongoing supervisory review of the effects and other consequences of the implementation of the Final Rule.

Final Rule Generally Adopts Proposed Rules

As noted in our recent Legal Update, the Final Rule generally adopted the rules for the treatment of securitization exposures under the regulatory capital framework that had been previously proposed[5] without significant change, except as noted below.[6]

Just as the June 2012 NPRs had proposed, the Final Rule substantially revises the risk-based regulatory capital framework for securitization exposures for all US banking organizations. These revisions include removing references to, and reliance on, credit ratings to determine risk weights for these exposures, as required by section 939A of the Dodd-Frank Act. As noted below, the Final Rule includes the controversial floor or minimum risk weight of 20 percent for any securitization exposure as well as the 1,250 percent risk weight in many circumstances in which the industry had sought relief.

Consistent with the securitization approach in effect for US advanced approaches banks under Basel II (US Basel II),[7] the Final Rule updates the terminology for the securitization framework to include a definition of securitization exposure that encompasses a wider range of exposures with similar risk characteristics. In addition, as was proposed in the June 2012 NPRs, the Final Rule implements new due diligence and other operational requirements for securitization exposures.

No Mention of BCBS Consultation Document 236

Somewhat curiously, the Final Rule makes no mention of the BCBS' December 2012 Consultative Document,[8] which proposed additional changes to the Basel III securitization framework. These changes included the introduction of a new maturity feature throughout the framework, starting with the modified supervisory formula approach or MSFA, that is based on the supervisory formula approach (SFA). Industry comments on this proposal have been critical of the significant increase in capital resulting from the new maturity factor as well as the relatively limited risk sensitivity in those approaches most likely to be used by banks as investors and the lack of consistency in resulting capital charges under the various alternative approaches. In rather sharp contrast to the absence of discussion of BCBS 236, the Final Rule extensively references the ongoing BCBS work-streams in other areas, including exposures to central counterparties (CCP) and over-the-counter (OTC) derivatives exposures, and specifically notes that the Final Rule will likely be revised when that other work is concluded.

Definitions of Securitization and Securitization Exposure

Consistent with the June 2012 NPRs and US Basel II, the Final Rule defines a securitization exposure as an on- or off-balance sheet credit exposure (including credit-enhancing representations and warranties) that arises from a traditional or synthetic securitization (including a resecuritization), or an exposure that directly or indirectly references a securitization exposure. The Agencies rejected objections to the proposal that the definition resulted in an overly broad scope and should be limited to exposures that tranche the credit risk associated with a pool of assets. According to the Agencies, both the designation of exposures as securitization exposures (or resecuritization exposures) and the calculation of risk-based capital requirements for securitization exposures under the Final Rule are guided by the economic substance of a transaction rather than its legal form. Provided there is tranching of credit risk, securitization exposures could include, among other things, ABS and MBS, loans, lines of credit, liquidity facilities, financial standby letters of credit, credit derivatives and guarantees, loan servicing assets, servicer cash advance facilities, reserve accounts, credit-enhancing representations and warranties, and credit-enhancing interest-only strips (CEIOs). Securitization exposures also include assets sold with retained tranches.

Traditional Securitization Defined

The Final Rule generally adopts the June 2012 NPRs' (and, in turn, US Basel II's) definition of traditional securitization, which requires that credit risk of one or more underlying exposures has been transferred to one or more third parties (other than through the use of credit derivatives or guarantees), where the credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority. It also includes certain other conditions, such as requiring all or substantially all of the underlying exposures to be financial exposures.

However, the Final Rule also excludes certain exposures from the securitization framework. Specifically, while tranching of credit risk associated with financial assets is often indicative of a securitization, the Agencies found that the securitization framework was not appropriate for tranched credit exposures to commercial or industrial companies or associated with non-financial assets. For example, the Final Rule explicitly states that specialized loans to finance the construction or acquisition of large-scale projects or commodities would not be securitization exposures since the assets backing the loans (the project facility or commodity being financed) are non-financial.

Exclusion for Operating Companies

The Final Rule retains the June 2012 NPR's proposed exclusion (currently in US Basel II) of an operating company from traditional securitizations, even if substantially all of its assets are financial. Operating companies generally refer to companies that are established to conduct business with clients with the intention of earning a profit in their own right and generally produce goods or provide services beyond the business of investing, reinvesting, holding, or trading in financial assets. Accordingly, an equity investment in an operating company generally would be an equity exposure. Under the Final Rule, banking organizations are operating companies and do not fall under the definition of a traditional securitization. However, investment firms that generally do not produce goods or provide services beyond the business of investing, reinvesting, holding, or trading in financial assets would not necessarily be operating companies under the Final Rule and, if so, would not qualify for this general exclusion from the definition of traditional securitization.

Despite comments that requested broader exclusions from traditional securitization for certain investment firms, the Final Rule only adds certain pension funds to the proposed exclusions. The Final Rule also retains the proposed discretion for the primary Federal supervisor of a banking organization to exclude from the definition of a traditional securitization those transactions in which the underlying exposures are owned by an investment firm that exercises "substantially unfettered control" over the size and composition of its assets, liabilities and off-balance sheet exposures.

In determining whether to exclude an investment firm from the securitization framework, the Agencies are to consider a number of factors, including the assessment of the transaction's leverage, risk profile, and economic substance. This supervisory exclusion gives the primary Federal supervisor discretion to distinguish structured finance transactions, to which the securitization framework is designed to apply, from those of flexible investment firms, such as certain hedge funds and private equity funds. Only investment firms that can easily change the size and composition of their capital structure, as well as the size and composition of their assets and off-balance sheet exposures, are eligible for the exclusion from the definition of traditional securitization under this provision. The Agencies do not consider managed collateralized debt obligation (CDO) vehicles, structured investment vehicles (SIVs), and similar structures, which allow considerable management discretion regarding asset composition but are subject to substantial restrictions regarding capital structure, to have "substantially unfettered control." As a result, such transactions will still meet the definition of traditional securitization under the Final Rule. These provisions largely repeat language from the June NPRs and existing US Basel II and thus offer no additional guidance on ambiguities that have arisen, including treatment of various types of exposures to hedge funds.

Scope-in Discretion Retained

In noting that the line between securitization exposures and non-securitization exposures may be difficult to identify in some circumstances, the Final Rule retains the power for the primary Federal supervisor to expand the scope of the securitization framework to include other transactions if doing so is justified by the economics of the transaction. Similar to the analysis for excluding an investment firm from treatment as a traditional securitization, the Agencies will consider the economic substance, leverage, and risk profile of a transaction to ensure that an appropriate risk-based capital treatment is applied. The Agencies will consider a number of factors when assessing the economic substance of a transaction including, for example, the amount of equity in the structure, overall leverage (whether on- or off-balance sheet), whether redemption rights attach to the equity investor, and the ability of the junior tranches to absorb losses without interrupting contractual payments to more senior tranches.

Synthetic Securitizations Defined

As in the proposal and US Basel II, a synthetic securitization is defined as 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); (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). The Final Rule further clarifies that transactions in which a portion of credit risk has been retained, not just transferred, through the use of credit derivatives is subject to the securitization framework.

Resecuritizations

Rejecting requests for an exclusion or at least a proportionate treatment for resecuritizations that include only a *de minimis* amount of another securitization exposure (for example, a collateralized loan obligation (CLO) transaction with a "basket" for up to 5% of its portfolio to include structured securities), the Final Rule retains the June 2012 NPRs' proposed definition of resecuritization. The definition of "resecuritization" is an on- or off-balance sheet exposure to a resecuritization; or an exposure that directly or indirectly references a resecuritization exposure and, consistent with Basel III, provides that an exposure to an asset-backed commercial paper (ABCP) program is not a resecuritization exposure if either: (1) the program-wide credit enhancement does not meet the definition of a resecuritization exposure; or (2) the entity sponsoring the program fully supports the commercial paper through the provision of liquidity so that the commercial paper holders effectively are exposed to the default risk of the sponsor instead of the underlying exposures. A pool-specific ABCP liquidity facility generally is not a resecuritization exposure under the Final Rule because the pool-specific liquidity facility represents a tranche of a single asset pool (that is, the applicable pool of financial exposures), provided that the pool itself contains no securitization exposures.

However, the Final Rule helpfully clarifies that a re-tranching of a single exposure (for example, a re-REMIC) is not a resecuritization and that pass-through securities do not tranche credit protection and, accordingly, are not securitization exposures.

Securitization Due Diligence Requirements

Consistent with the proposal, the Final Rule requires banking organizations to satisfy specific due diligence and other operational requirements for securitization exposures, including the requirement that the banking organization demonstrate, to the satisfaction of its primary Federal supervisor, a comprehensive understanding of the features of a securitization exposure that would materially affect its performance. The banking organization's analysis would have to be commensurate with the complexity of the exposure and the materiality of the exposure in relation to capital of the banking organization. On an ongoing basis (and no less frequently than quarterly), the banking organization must evaluate, review, and update as appropriate the analysis required under the Final Rule for each securitization exposure. The analysis of the risk characteristics of the securitization exposure prior to acquisition, and periodically thereafter, will have to consider:

1) structural features of the securitization that materially impact the performance of the exposure; for example, the contractual cash-flow waterfall, waterfall-related triggers, credit enhancements, liquidity enhancements, market value triggers, the performance of organizations that service the position, and deal-specific definitions of default;
2) relevant information regarding the performance of the underlying credit exposure(s); for example, the percentage of loans 30, 60, and 90 days past due; default rates; prepayment rates; loans in foreclosure; property types; occupancy; average credit score or other measures of creditworthiness; average loan-to-value (LTV) ratio; and industry and geographic diversification data on the underlying exposure(s);
3) relevant market data of the securitization; for example, bid-ask spread, most recent sales price and historical price volatility, trading volume, implied market rating, and size, depth, and concentration level of the market for the securitization; and
4) for resecuritization exposures, performance information on the underlying securitization exposures; for example, the issuer name and credit quality, and the characteristics and performance of the exposures underlying the securitization exposures.

Failure to satisfy these due diligence requirements results in a 1250% risk weight to the securitization exposure. However, while the Agencies rejected requests for more moderate consequences depending on the degree and frequency of the failure, the preamble to the Final Rule suggests that the Agencies may permit appropriate flexibility where, for example, market data is not available (e.g., for foreign exposures) or loan-level data is not available (in which case the Agencies indicate that pool-level data can be used).

Securitization Operational Requirements

General. As for related operational requirements, under the Final Rule and consistent with the proposal and US Basel II, a banking organization that transfers exposures it has originated or purchased to a securitization SPE or other third party in connection with a traditional securitization can exclude the underlying exposures from the calculation of risk-weighted assets only if each of the following conditions are met:

1) the exposures are not reported on the banking organization's consolidated balance sheet under GAAP;
2) the banking organization has transferred to one or more third parties credit risk associated with the underlying exposures; and
3) any clean-up calls relating to the securitization are eligible clean-up calls.

An originating banking organization that meets these conditions must hold risk-based capital against any credit risk it retains or acquires in connection with the securitization. An originating banking organization that fails to meet these conditions is required to hold risk-based capital against the transferred exposures as if they had not been securitized and must deduct from common equity tier 1 (CET1) capital any after-tax gain-on-sale resulting from the transaction.

In addition, consistent with the proposal and in a change from the current rules, if a securitization (1) includes one or more underlying exposures in which the borrower is permitted to vary the drawn amount within an agreed limit under a line of credit, and (2) contains an early amortization provision, the originating banking organization is required to hold risk-based capital against the transferred exposures as if they had not been securitized and deduct from CET1 capital any after-tax gain-on-sale resulting from the transaction.

Special Requirements for Synthetic Securitizations. In general, the operational requirements for synthetic securitizations under the Final Rule are similar to those for traditional securitizations. However, these operational requirements are more detailed to ensure that the originating banking organization has truly transferred credit risk of the underlying exposures to one or more third parties. Under the June 2012 NPRs, an originating banking organization would have been able to recognize for risk-based capital purposes the use of a credit risk mitigant to hedge underlying exposures only if each of the conditions in the definition of "synthetic securitization" was satisfied. However, to ensure that synthetic securitizations created through tranched guarantees and credit derivatives are properly included in the securitization framework, the Final Rule amends the operational requirements to recognize guarantees and credit derivatives that meet all of the criteria set forth in the definition of eligible guarantee or eligible credit derivative except the requirement that the guarantee [or obligation] be unconditional. As a result, a guarantee or credit derivative that provides a tranched guarantee would not be excluded by the operational requirements for synthetic securitizations.

Failure to meet these operational requirements for a synthetic securitization prevents a banking organization that has purchased tranched credit protection referencing one or more of its exposures from using the securitization framework with respect to the reference exposures. Instead, the banking organization must hold risk-based capital against the underlying exposures as if they had not been synthetically securitized. If the operational requirements are met, a banking organization that holds a synthetic securitization as a result of purchasing credit protection may use the securitization framework to determine the risk-based capital requirement for its exposure. Alternatively, it may choose to disregard the credit protection and use the general credit risk framework. A banking organization that provides tranched credit protection in the form of a synthetic securitization or credit protection to a synthetic securitization *must* use the securitization framework to compute risk-based capital requirements for its exposures to the synthetic securitization even if the originating banking organization fails to meet one or more of the operational requirements for a synthetic securitization.

Clean-Up Calls

As proposed, and consistent with US Basel II, the Final Rule requires that, to satisfy the operational requirements for securitizations and enable an originating banking organization to exclude the underlying exposures from the calculation of its risk-based capital requirements, any clean-up call associated with a securitization would need to be an eligible clean-up call. In the case of a traditional securitization, a clean-up call generally is accomplished by the originator repurchasing the remaining securitization exposures once the amount of underlying exposures or outstanding securitization exposures falls below a specified level. In the case of a synthetic securitization, the clean-up call may take the form of a clause that extinguishes the credit protection once the amount of underlying exposures has fallen below a specified level.

The Final Rule continues to define an eligible clean-up call as a clean-up call that is a contractual provision that permits an originating banking organization or servicer to call securitization exposures before their stated maturity or call date and that (1) is exercisable solely at the discretion of the originating banking organization or servicer; (2) is not structured to avoid allocating losses to securitization exposures held by investors or otherwise structured to provide credit enhancement to the securitization (for example, to purchase non-performing underlying exposures); and (3) (a) for a traditional securitization, is only exercisable 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, is only exercisable 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.

When 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 meets criteria (3) of the definition of "eligible clean-up call" as long as the outstanding principal amount in that series or tranche was 10 percent or less of its original amount at the inception of the series.

Alternative Approaches to Determine Risk-Weighted Capital

Consistent with the June 2012 NPRs, the framework for assigning risk-based capital requirements to securitization exposures in the Final Rule will require banking organizations generally to calculate a risk-weighted asset amount for a securitization exposure by applying either (i) the simplified supervisory formula approach (SSFA) or (ii) if the banking organization is a Standardized Bank that is not subject to the market risk rule, a "gross-up" approach similar to an approach provided under the general risk-based capital rules. A banking organization would be required to apply either the SSFA or the gross-up approach consistently across all of its securitization exposures. If an Advanced Bank has the required data to do so (which may include loan level in some cases), such bank must instead use the more risk sensitive supervisory formula approach as in US Basel II, but with changes to the formula that yield a higher capital charge. The gross-up approach is not available to Advanced Banks.

Pursuant to Section 939A of Dodd-Frank, the ratings-based approach in the US existing capital rules (including US Basel II) has been eliminated. The Agencies determined that the SSFA is an appropriate substitute standard to credit ratings that can be used to measure risk-based capital requirements and may be implemented uniformly across institutions. In addition, despite industry objections that it adversely affected banks that maintained capital ratios above the regulatory minimums, the Agencies retained use of a 1,250 percent risk weight rather than a capital deduction for certain securitization exposures (and for similar treatment elsewhere in the Final Rule) noting that use of the 1,250 percent risk weight was simpler and provided for comparability in risk-weighted asset amounts for the same exposure across institutions.

There are some exceptions to the general provisions in the securitization framework that parallel the general risk-based capital rules. First, a banking organization is required to assign a risk-weight of at least 100 percent to an interest-only MBS. The Agencies state that a minimum risk-weight of 100 percent is prudent in light of the uncertainty implied by the substantial price volatility of these securities. Second, as required by federal statute, special rules continue to apply to securitizations of small-business loans and leases on personal property transferred with retained contractual exposure by well-capitalized depository institutions.

Consistent with the proposal, the Final Rule provides for an alternative treatment of securitization exposures to ABCP programs and certain gains-on-sale and credit-enhancing interest-only (CEIO) exposures, both as further described below. Similar to the general risk-based capital rules, the Final Rule also includes a minimum 100 percent risk-weight for interest-only mortgage-backed securities and exceptions to the securitization framework for certain small-business loans and certain derivatives, also as described below. A banking organization may use the securitization credit risk mitigation rules to adjust the capital requirement under the securitization framework for an exposure to reflect certain collateral, credit derivatives, and guarantees.

Amounts of Exposures for Which Risk-Based Capital Required

Under the Final Rule, the exposure amount of an on-balance sheet securitization exposure that is not a repo-style transaction, eligible margin loan, OTC derivative contract, or derivative that is a cleared transaction is generally the banking organization's carrying value of the exposure. However, if a securitization exposure is an OTC derivative contract or derivative contract that is a cleared transaction (other than a credit derivative) that has a first priority claim on the cash flows from the underlying exposures (notwithstanding amounts due under interest rate or currency derivative contracts, fees due, or other similar payments), a banking organization may choose to set the risk-weighted asset amount of the exposure equal to the amount of the underlying exposure.

The exposure amount of an off-balance sheet securitization exposure that is not an eligible ABCP liquidity facility, a repo-style transaction, eligible margin loan, an OTC derivative contract (other than a credit derivative), or a derivative that is a cleared transaction (other than a credit derivative) is the notional amount of the exposure.

For purposes of calculating the exposure amount of an off-balance sheet exposure to an ABCP securitization exposure, such as a liquidity facility, consistent with the June 2012 NPRs, under both the standardized and advanced approaches, the notional amount may be reduced to the maximum potential amount that the banking organization could be required to fund given the ABCP program's current underlying assets (calculated without regard to the current credit quality of those assets).

Under the Final Rule's standardized approach, the exposure amount of an eligible ABCP liquidity facility that is subject to the SSFA equals the notional amount of the exposure multiplied by a 100 percent credit conversion factor (CCF). However, a Standardized Bank can use a 50 percent CCF to calculate the exposure amount of an eligible ABCP liquidity facility that is not subject to the SSFA. The exposure amount of a securitization exposure that is a repo-style transaction, eligible margin loan, an OTC derivative contract (other than a purchased credit derivative), or derivative that is a cleared transaction (other than a purchased credit derivative) is the exposure amount of the transaction as calculated under section 34 [OTC derivative contracts] or section 37 [Collateralized transactions] of the Final Rule, as applicable.

Double-Counting Avoided

Consistent with the proposal and US Basel II, the Final Rule includes provisions to limit the double-counting of risks in situations involving overlapping securitization exposures. If a banking organization has multiple securitization exposures that provide duplicative coverage to the underlying exposures of a securitization (such as when a banking organization provides a program-wide credit enhancement and multiple pool-specific liquidity facilities to an ABCP program), the banking organization is not required to hold duplicative risk-based capital against the overlapping position. Instead, the banking organization must apply to the overlapping position the applicable risk-based capital treatment under the securitization framework that results in the highest risk-based capital requirement.

Servicer Advances

A traditional securitization often employs a servicing banking organization that, on a day-to-day basis, collects principal, interest, and other payments from the underlying assets of the securitization and forwards such payments to the securitization SPE or to investors in the securitization. Servicing banking organizations often provide a facility to the securitization under which the servicing banking organization may advance cash to ensure an uninterrupted flow of payments to investors in the securitization, including advances made to cover foreclosure costs or other expenses to facilitate the timely collection of the underlying exposures. These servicer cash advance facilities are treated as securitization exposures for regulatory capital purposes. Consistent with the proposal, under the Final Rule a banking organization must apply the SSFA or the gross-up approach, as described below, or a 1,250 percent risk-weight to a servicer cash advance facility. The treatment of the undrawn portion of the facility depends on whether the facility is an eligible servicer cash advance facility. An “eligible servicer cash advance facility” is a servicer cash advance facility in which: (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.

Consistent with the proposal, a banking organization that is a servicer under an eligible servicer cash advance facility will not be required to hold risk-based capital against potential future cash advances that it may be required to provide under the contract governing the facility. Under the proposal, a banking organization that provides a non-eligible servicer cash advance facility would have determined its risk-based capital requirement for the notional amount of the undrawn portion of the facility in the same manner as for other off-balance sheet securitization exposures. The Final Rule clarifies that a banking organization that is a servicer under a non-eligible servicer cash advance facility must hold risk-based capital against the amount of all potential future cash advance payments that it may be contractually required to provide during the subsequent 12-month period under the contract governing the facility.

SSFA

To replace the ratings-based approach as a method to assign risk weights to securitization exposures, the June 2012 NPRs introduced a simplified version (SSFA) of the supervisory formula approach (SFA) that had existed in US Basel II. In the Final Rule, the Agencies acknowledge that there may be differences in capital requirements under the SSFA and the ratings-based approach in the Basel capital framework and note that any alternative standard developed by the Agencies may not generate the same result as a ratings-based capital framework under every circumstance. However, the Agencies state that they have designed the SSFA to result in generally comparable capital requirements to those that would be required under the Basel ratings-based approach without undue complexity. The Agencies will monitor implementation of the SSFA and, based on supervisory experience, consider what modifications, if any, may be necessary to improve the SSFA in the future.

The Agencies have adopted the SSFA largely as proposed, with revisions to the delinquency parameter (parameter *W*) that are intended to clarify the operation of the formula when the contractual terms of the exposures underlying a securitization permit borrowers to defer payments of principal and interest, as described below. The SSFA applies a 1,250 percent risk-weight to securitization exposures that absorb losses up to the amount of capital that would be required for the underlying exposures under subpart D (the standardized approach) of the Final Rule had those exposures been held directly by a banking organization. In addition, the Final Rule implements the controversial proposed supervisory *risk weight floor* or *minimum risk weight* for a given securitization of *20 percent*.

At the inception of a securitization, the SSFA requires more capital on a transaction-wide basis than would be required if the underlying assets had not been securitized. That is, if the banking organization held every tranche of a securitization, its overall capital requirement would be greater than if the banking organization held the underlying assets in its own unsecuritized portfolio. In response to industry criticism of this aspect of the proposal, the Agencies simply stated their belief in the Final Rule that this overall outcome is important in reducing the likelihood of regulatory capital arbitrage through securitizations.

The June 2012 NPRs had proposed that data for SSFA parameters may not be more than 91 days old. Commenters had requested that this requirement be relaxed for securitizations of underlying assets with longer payment periods. In response, the Final Rule requires that the most current available data be used, but retains the specific 91 days' requirement for exposures with monthly or quarterly payments.

In order to use the SSFA, a banking organization must obtain or determine the weighted-average risk-weight of the underlying exposures (K_G), as well as the attachment and detachment points for the banking organization's position within the securitization structure. "K_G" is calculated using the risk-weighted asset amounts in the standardized approach and is expressed as a decimal value between zero and 1 (that is, an average risk weight of 100 percent means that K_G would equal 0.08). The banking organization may recognize the relative seniority of the exposure, as well as all cash funded enhancements, in determining attachment and detachment points. Commenters to this aspect of the proposal expressed concern over the level of detail necessary to calculate K_G (particularly for residential mortgage-backed exposures). In response, the Agencies noted that the Final Rule's abandonment of the more complex and controversial risk-weighting regime for residential mortgage significantly mitigated any such concerns. In addition, despite commenters characterizing the K_G parameter as not sufficiently risk sensitive and specifically as not taking into account sequential pay structures or other cash-flow waterfall structures, the Final Rule adopts the K_G parameter as proposed, which includes the K_A parameter that first appeared in the Market Risk Rule (the K_G parameter adjusted for delinquencies among the underlying assets) to make the SSFA more risk-sensitive and forward-looking. K_A is set equal to the weighted average of the K_G value and a fixed parameter equal to 0.5.

$K_A = (1\text{-}W).K_G + (0.5.W)$

Under the June 2012 NPRs, the *W* parameter would have equaled the ratio of the sum of the dollar amounts of any underlying exposures of the securitization that are 90 days or more past due, subject to a bankruptcy or insolvency proceeding, in the process of foreclosure, held as real estate owned, in default, or have contractually deferred interest for 90 days or more divided by the ending balance, measured in dollars, of the underlying exposures. Commenters had expressed concern that the proposal would require additional capital for payment deferrals that are unrelated to the creditworthiness of the borrower (such as the case for guaranteed student loans). The Agencies did respond favorably to this comment by excluding from *W* in the Final Rule contractual deferrals on Federally-guaranteed student loans or on other consumer loans if the contractual deferral was in place at the time funds were disbursed and not related to the borrower's creditworthiness.

Gross-Up Approach

The gross-up approach is available for Standardized Banks only and is designed to allow such banks to use a simple method to calculate required capital against their securitization exposures. To calculate risk-weighted assets under the gross-up approach, a banking organization determines four inputs: the *pro rata* share, the exposure amount, the enhanced amount, and the applicable risk weight. The *pro rata* share is the par value of the banking organization's exposure as a percentage of the par value of the tranche in which the securitization exposure resides. The enhanced amount is the par value of all the tranches that are more senior to the tranche in which the exposure resides. The applicable risk weight is the weighted-average risk weight of the underlying exposures in the securitization as calculated under the standardized approach (similar to K_G in the SSFA).

Under the gross-up approach, a banking organization is required to calculate the credit equivalent amount, which equals the sum of (1) the amount of the banking organization's securitization exposure and (2) the *pro rata* share multiplied by the enhanced amount. To calculate risk-weighted assets for a securitization exposure under the gross-up approach, a banking organization is required to assign the applicable risk weight to the gross-up credit equivalent amount. As noted above, in all cases, the *minimum risk weight* for securitization exposures is *20 percent*.

Alternative Treatments For Certain Types of Securitizations

Under the Final Rule a banking organization generally would assign a 1,250 percent risk weight to any securitization exposure to which the banking organization does not apply the SFA, the SSFA or the gross-up approach. However, the Final Rule provides alternative treatments for certain types of securitization exposures described below, provided that the banking organization knows the composition of the underlying exposures at all times.

Eligible Asset-backed Commercial Paper Liquidity Facilities. Under the Final Rule, consistent with the Basel capital framework, under the standardized approach a banking organization is permitted to determine the risk-weighted asset amount of an eligible ABCP liquidity facility by multiplying the exposure amount by the highest risk weight applicable to any of the individual underlying exposures covered by the facility.

A Securitization Exposure in a Second-loss Position or Better to an Asset-backed Commercial Paper Program. Under the Final Rule, under the standardized approach a banking organization may determine the risk-weighted asset amount of a securitization exposure that is in a second-loss position or better to an ABCP program by multiplying the exposure amount by the higher of 100 percent and the highest risk weight applicable to any of the individual underlying exposures of the ABCP program, provided the exposure meets the following criteria:

1) The exposure is not an eligible ABCP liquidity facility;
2) The exposure is economically in a second-loss position or better, and the first-loss position provides significant credit protection to the second-loss position;
3) The exposure qualifies as investment grade; and

4) The banking organization holding the exposure does not retain or provide protection for the first-loss position.

Credit Risk Mitigation for Securitization Exposures

Under the Final Rule, the treatment of credit risk mitigation for securitization exposures would differ slightly from the treatment for other exposures. To recognize the risk-mitigating effects of financial collateral or an eligible guarantee or an eligible credit derivative from an eligible guarantor, a banking organization that purchases credit protection uses the approaches for collateralized transactions under the Final Rule [section 37] or the substitution treatment for guarantees and credit derivatives described in the Final Rule [section 36]. In cases of maturity or currency mismatches, or, if applicable, lack of a restructuring event trigger, the banking organization must make any applicable adjustments to the protection amount of an eligible guarantee or credit derivative as required by section 36 [Guarantees and credit derivatives; substitution treatment] for any hedged securitization exposure. In addition, for synthetic securitizations, when an eligible guarantee or eligible credit derivative covers multiple hedged exposures that have different residual maturities, the banking organization is required to use the longest residual maturity of any of the hedged exposures as the residual maturity of all the hedged exposures. In the Final Rule, the Agencies clarify that a banking organization is not required to compute a counterparty credit risk capital requirement for the credit derivative provided that this treatment is applied consistently for all of its OTC credit derivatives. However, a banking organization must calculate counterparty credit risk if the OTC credit derivative is a covered position under the Market Risk Rule.

A banking organization that purchases an OTC credit derivative (other than an n^{th}-to-default credit derivative) that is recognized as a credit risk mitigant for a securitization exposure that is not a covered position under the market risk rule is not required to compute a separate counterparty credit risk capital requirement provided that the banking organization does so consistently for all such credit derivatives. The banking organization must either include all or exclude all such credit derivatives that are subject to a qualifying master netting agreement from any measure used to determine counterparty credit risk exposure to all relevant counterparties for risk-based capital purposes. If a banking organization cannot, or chooses not to, recognize a credit derivative that is a securitization exposure as a credit risk mitigant, the banking organization must determine the exposure amount of the credit derivative under the treatment for OTC derivatives in the Final Rule. The Final Rule clarifies that if the banking organization purchases the credit protection from a counterparty that is a securitization, the banking organization must determine the risk weight for counterparty credit risk according to the securitization framework. If the banking organization purchases credit protection from a counterparty that is not a securitization, the banking organization must determine the risk weight for counterparty credit risk according to general risk weights under the Final Rule. A banking organization that provides protection in the form of a guarantee or credit derivative (other than an n^{th}-to-default credit derivative) that covers the full amount or a *pro rata* share of a securitization exposure's principal and interest must risk weight the guarantee or credit derivative as if it holds the portion of the reference exposure covered by the guarantee or credit derivative.

Nth-to-default Credit Derivatives

Under the Final Rule, the capital requirement for credit protection provided through an nth-to-default credit derivative is determined either by using the SSFA (for a Standardized Bank; an Advanced Bank must use the SFA if the required data is available), or applying a 1,250 percent risk weight. A banking organization providing credit protection must determine its exposure to an nth-to-default credit derivative as the largest notional amount of all the underlying exposures. When applying the SSFA, the attachment point (parameter *A*) is the ratio of the sum of the notional amounts of all underlying exposures that are subordinated to the banking organization's exposure to the total notional amount of all underlying exposures. In the case of a first-to-default credit derivative, there are no underlying exposures that are subordinated to the banking organization's exposure. In the case of a second-or-subsequent-to default credit derivative, the smallest (n-1) underlying exposure(s) are subordinated to the banking organization's exposure. Under the SSFA, the detachment point (parameter *D*) is the sum of the attachment point and the ratio of the notional amount of the banking organization's exposure to the total notional amount of the underlying exposures. A banking organization that does not use the SSFA to calculate a risk weight for an nth-to-default credit derivative would assign a risk weight of 1,250 percent to the exposure. For protection purchased through a first-to-default derivative, a banking organization that obtains credit protection on a group of underlying exposures through a first-to-default credit derivative that meets the rules of recognition for guarantees and credit derivatives under the Final Rule must determine its risk-based capital requirement for the underlying exposures as if the banking organization synthetically securitized the underlying exposure with the smallest risk-weighted asset amount and had obtained no credit risk mitigant on the other underlying exposures. A banking organization must calculate a risk-based capital requirement for counterparty credit risk according to section 34 of the Final Rule [OTC derivative contracts] for a first-to-default credit derivative that does not meet the rules of recognition of section 36(b).

For second-or-subsequent-to-default credit derivatives, a banking organization that obtains credit protection on a group of underlying exposures through an nth-to-default credit derivative that meets the rules of recognition of section 36(b) of the Final Rule (other than a first-to-default credit derivative) may recognize the credit risk mitigation benefits of the derivative only if the banking organization also has obtained credit protection on the same underlying exposures in the form of first-through-(n-1)-to-default credit derivatives; or if n-1 of the underlying exposures have already defaulted. If a banking organization satisfies these requirements, the banking organization determines its risk-based capital requirement for the underlying exposures as if the banking organization had only synthetically securitized the underlying exposure with the nth smallest risk-weighted asset amount and had obtained no credit risk mitigant on the other underlying exposures. For an nth-to-default credit derivative that does not meet the rules of recognition of section 36(b), a banking organization must calculate a risk-based capital requirement for counterparty credit risk according to the treatment of OTC derivatives under section 34 of the Final Rule [OTC derivative contracts].

Pillar 3 Disclosures for Securitization

Stating that significant market uncertainty during the recent financial crisis was caused by the lack of disclosures regarding banking organizations' securitization-related exposures, the Final Rule adopts the enhanced disclosures proposed in the June 2012 NPRs, including the following:

1) The nature of the risks inherent in a banking organization's securitized assets,
2) A description of the policies that monitor changes in the credit and market risk of a banking organization's securitization exposures,
3) A description of a banking organization's policy regarding the use of credit risk mitigation for securitization exposures,
4) A list of the special purpose entities a banking organization uses to securitize exposures and the affiliated entities that a bank manages or advises and that invest in securitization exposures or the referenced SPEs, and
5) A summary of the banking organization's accounting policies for securitization activities.

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Footnotes

[1] Namely, the Federal Reserve Board of Governors (FRB), the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC).

[2] The final rules (and, in the case of the FDIC, the interim final rule) as adopted and sharing substantially common text are available at: http://www.federalreserve.gov/bcreg20130702a.pdf (FRB); http://occ.gov/news-issuances/news-releases/2013/2013-110a.pdf (OCC); and http://fdic.gov/news/board/2013/2013-07-09_notice_dis_a_res.pdf (FDIC).

[3] More details of which are available at: http://www.bis.org/bcbs/basel3.htm?ql=1 and with which we assume readers of this update will be generally familiar.

[4] Our recent related Legal Update summarizes the Final Rule and is available at: http://www.mayerbrown.com/Bank-Regulators-Approve-Final-Rule-to-Implement-Basel-III-Capital-Requirements-in-the-United-States-07-15-2013/.

[5] The Final Rule incorporates and consolidates three separate notices of proposed rulemaking (collectively, the June 2012 NPRs): "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action," 77 Fed Reg. 52792 (Aug. 30, 2012) (the Basel III NPR); "Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements," 77 Fed. Reg. 52888 (Aug. 30, 2012) (the Standardized Approach NPR); and "Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule," 77 Fed. Reg. 52978 (Aug. 30, 2012) (the Advanced Approaches NPR). For a brief summary of the June 2012 NPRs, see our related Legal Update available at http://www.mayerbrown.com/publications/detail.aspx?publication=8039.

[6] Except as otherwise indicated, the revisions discussed herein apply both to banking organizations that are subject to the advanced approaches method of computing risk-based capital (Advanced Banks) and to those subject only to the standardized approach of computing risk-based capital (Standardized Banks).

[7] Federal Register, Vol. 72, p. 69288 (December 10, 2007).

[8] BCBS, Revisions to the Basel Securitisation Framework – Consultative Document (December 2012), available at http://www.bis.org/publ/bcbs236.pdf. Our related Legal Update discussing these proposals is available at: http://www.mayerbrown.com/revisions-basel-framework/.

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