

Clients & Friends Memo

Basel Committee Changes to the Securitisation Framework

26 February 2004 The Basel Committee¹ on Banking Supervision (the “Committee”) recently issued a report entitled “Changes to the Securitisation Framework” (the “Report”) that has revised, in certain respects, the internal ratings-based approach to securitization exposures detailed in the third consultative paper (“CP3”) issued in April 2003. The Report sets forth in full the proposed revisions that the Committee had originally announced in its press release of January 15, 2004 and that were summarized in our Clients and Friends Memorandum of January 18, 2004.

Internal Assessment Approach

The Committee has introduced an Internal Assessment Approach (“IAA”) that may be used to determine capital charges for unrated liquidity facilities and credit enhancements that banks extend to asset-backed commercial paper (“ABCP”) conduits. The IAA would be applicable only to exposures to ABCP conduits that have an internal rating equivalent of investment-grade at inception.

Subject to the satisfaction of certain operational requirements set forth in Annex A to the Report (a copy of which is attached hereto as Exhibit A), banks would derive their internal assessments of such liquidity and credit exposures based on rating agency criteria for the relevant asset type. The notional amount of the exposure would then be assigned the risk weight corresponding to the position’s seniority, granularity and external rating equivalent under the Ratings Based Approach (“RBA”).

Simplification of the Supervisory Formula

A significant amount of criticism of the CP3 Supervisory Formula (“SF”) focused on its complexity and the corresponding computational burden that its use imposed upon banks. In a response to these criticisms, the Committee has simplified the formula (the “Simplified SF”) into a single algebraic equation based on four bank-supplied inputs: (1) the capital charge that would be applied had the assets not been securitized (K_{RB} , which, as in CP3, will continue to be defined as the sum of expected and unexpected losses); (2) the degree of credit enhancement supporting a given position (L); (3) the thickness of the exposure in question (T);

¹ The Basel Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

and (4) the effective number of exposures in the securitized pool (N). In contrast to the SF discussed in CP3, the simplified version would not result in different capital requirements in cases where two pools may have the same K_{IRB} , but different exposure-weighted average loss-give-default amounts (“LGDs”). Accordingly, the revisions eliminate that average as an input to the Simplified SF. The Simplified SF may be applied to all unrated exposures, including liquidity facilities and credit enhancements provided to ABCP conduits.

Modifications to Top-Down Approach for Calculating K_{IRB}

In numerous comment letters provided with respect to CP3, market participants raised concerns about their ability to calculate K_{IRB} , an input to the SF, for securitization exposures subject to the “top-down” Internal Ratings-Based (“IRB”) approach outlined in CP3. These comment letters indicated that it would be difficult for banks to reliably break down their expected loss estimates into Probability of Default (“PD”) and LGD components. As a result, they would be required under CP3 to assign a LGD of 100% to such exposures. Combined with the conservative treatment of dilution risk contained in CP3, the capital charge associated with the top-down approach was considered by these commenters to be unduly harsh.

The Committee states in the Report that it’s planning to develop operational criteria that will allow banks to rely on their own LGD estimates for securitization exposures, particularly for exposures to ABCP conduits. The Committee has also said that it recognizes that requiring capital for both dilution risk and default risk may represent the double counting of risk, and it is working to resolve this issue.

Consistency Within the Securitization Framework

The Report eliminates certain differences under CP3 in the treatment of securitization exposures held by originators and those held by investors. Under the CP3 approach, originating banks, but not investors, were required to deduct all positions that fell below K_{IRB} . Under the new approach provided for in the Report, originators are permitted to apply the RBA risk weights to all rated positions at or above a Ba3 rating level, even if they fall below the K_{IRB} boundary. The cap on an originating bank’s maximum capital requirement will remain in place.

Treatment of Rated Securitization Positions

The Committee has revised the risk weights applied under the RBA in order to better align those risk weights with the level of risk inherent in securitization exposures. Under CP3 the RBA applied only to externally rated positions and, on a limited basis, to circumstances in which an inferred rating could be applied. As discussed above, under the Report the RBA would also be used for mapping internal assessments under the IAA to risk capital charges.

1. Greater Focus on Seniority

The revisions to be made to the RBA will significantly change the group of exposures eligible for the lowest set of risk weights (found in the left most column of the RBA risk weight tables in CP3). In particular, the focus of the exposures eligible for the lowest set of risk weights under the RBA has changed from the concept of “thickness” to “seniority.” This new approach could disqualify some “thick” and “granular” tranches from the use of the most preferential risk weights available to such tranches under the criteria detailed in CP3. The Committee is currently evaluating the implications of this change on various securitization exposures, including super-senior positions arising from synthetic structures.

2. Enhance Sensitivity to Risk of Highly-Rated Exposures

In addition to expanding the eligibility for preferential risk weights, the Report provides for further differentiation between the most preferential risk weights. As illustrated in the table below, separate risk weights would be specified for (1) senior, granular tranches; (2) non-senior, granular tranches (the “Base Case”); and (3) tranches backed by non-granular pools. Except where indicated by text within the double-lined boxes in the table, the risk weights under the alternative RBA risk weight scheme will be the same as those proposed in CP3.

Alternative RBA Risk Weights

Rating Grade (Illustrative)	CP3 Risk Weights (%)			Alternative Risk Weights (%)		
	Highly granular pools, thick tranches ²	Base Case	Non-granular Pool	Senior Tranches and eligible senior IAA	Base Case	Non-granular Pool
Aaa	7	12	20	7	12	20
Aa	10	15	25	8	15	25
A1	20	35	35	10	18	35
A2				12	20	
A3				20	35	
Baa1	50			35	50	
Baa2	75			60	75	
Baa3	100			100		
Ba1	250			250		
Ba2	425			425		
Ba3	650			650		
Below-Ba3	Deduction			Deduction		

For purposes of the RBA, a securitization exposure will be treated as a senior tranche if it is effectively backed or secured by a first claim on the entire amount of the assets in the underlying securitized pool. While this generally will include only the most senior position within a securitization transaction, in some instances there will be some other claim that, in a technical sense, may be more senior in the waterfall but will be disregarded for the purpose of determining which positions are subject to the “senior tranches” column.

The Committee also acknowledged that it considered whether to differentiate RBA risk weights by asset type, based on quantitative information provided by market participants that indicated that the likelihood of credit events and the magnitude of the related effect of any such credit events have historically differed substantially for ABS and MBS backed by different underlying asset types. However, the Committee stated that it does not believe that such differentiation would result in a material improvement in risk sensitivity, and so has not provided different RBA risk weights for ABS and MBS backed by different underlying asset types.

² See paragraph 585 of CP3 for the definition of this category.

Implications of Calibrating Risk Weights to UL Only

The Committee considered the implications for the securitization framework of calibrating the overall regulatory risk weight framework to unexpected losses (“UL”) only. The Report states that the Committee sought to propose the simplest way to distinguish between UL and expected losses (“EL”) in securitization exposures to minimize the computational burden. The K_{IRB} input to the Simplified SF will continue to be measured as the sum of the UL and EL portions of credit risk associated with the underlying exposures had they not been securitized. Since a calculation of EL is still required for on-balance sheet credit exposures under the UL-only framework, the Committee indicated that it believes that this approach will not increase operational burdens on banks.

The Committee concluded that the EL component of the capital charges in more senior securitization tranches tends to be very small relative to the UL component. Accordingly, the Committee also concluded that for these tranches decomposing the risk weights into EL and UL portions would add complexity but would not increase risk sensitivity. The Report therefore proposes to treat the capital requirements as fully representing capital against UL for securitization positions rated no lower than Ba3 and for unrated portions above K_{IRB} .

For positions under the RBA that are below Ba3 and for other positions that fall below K_{IRB} , the Report maintains the CP3 proposed treatment of deduction. In addition, deduction of the whole amount of K_{IRB} from capital would be considered the maximum capital requirement regardless of whether the position is below or above K_{IRB} and regardless of whether it is rated or unrated. The Committee is reviewing the treatment of credit-enhancing interest-only strips to determine whether all of these should be deducted from capital and to what degree such deductions should be subject to the maximum capital charge of K_{IRB} .

The Committee has stated that when a bank is required to deduct a position related to a securitization exposure, the deduction should be carried out first and before the calculation of the overall excess/shortfall of provisions. Only specific provisions set aside against securitization exposures, if any, can be used to offset this deduction amount.

If you would like to discuss any aspect of the Report, please contact Jim Croke at +44 20 7170 8758 or Peter Manbeck at +1 212 504 6626.

EXHIBIT A**Draft Operational Requirements for the Internal Assessment Approach to Securitization Exposures****Operational Requirements for use of the Asset-Backed Commercial Paper Program Internal Assessment Approach (IAA)**

1. An asset-backed commercial paper (ABCP) program is a program that issues commercial paper with an original maturity of one year or less that is backed by assets or other exposures held in a bankruptcy-remote, special purpose entity. A bank that provides liquidity facilities and/or credit enhancements to an ABCP program may use its internal assessments of its exposures to the program to determine their IRB capital requirements. Such exposures typically are of high credit quality. A bank's internal assessment process must meet the following operational requirements in order to use internal assessments in determining the IRB capital requirement arising from liquidity facilities, credit enhancements, or other exposures extended to an ABCP program, with the exception of the commercial paper itself. The ABCP must be externally rated for the unrated exposure to qualify for the IAA. These ABCPs themselves would be subject to the Ratings-Based Approach (RBA). In addition, banks must adhere to any other applicable supervisory guidance related to ABCP programs.

- (a) The internal assessment of a liquidity facility or credit enhancement's credit quality must be based on an external credit assessment institution's (ECAI) criteria for the asset type purchased and must be the equivalent of at least investment grade when initially assigned to an exposure. In addition, the internal assessment must be used in the bank's internal risk management processes, including management information and economic capital systems, and generally must meet all the relevant requirements in order to be eligible for use under the IRB framework.
- (b) In order for banks to use the IAA, their supervisors must be satisfied (1) that the ECAI meets the ECAI eligibility outlined in the New Basel Capital Accord and (2) with the ECAI rating methodologies used in the process. In addition, banks have the responsibility to demonstrate to the satisfaction of their supervisors how these internal assessments correspond with the ECAI standards used as the framework for use of this internal assessment approach.

For instance, when calculating the credit enhancement level in the context of the IAA, supervisors may, if warranted, disallow on a full or partial basis any seller provided recourse guarantees or excess spread, or any other first loss credit enhancements that provide limited protection to the bank.

- (c) The bank's internal assessment process must identify gradations of risk. Internal assessments must correspond to the external ratings of ECAs so that supervisors can determine which internal assessment corresponds to each external rating category of the ECAs.
- (d) The bank's internal assessment process, particularly the stress factors for determining credit enhancement requirements, must be at least as conservative as major ECAs' published rating criteria for the asset type being purchased by the ABCP program.

- In the case where different ECAIs' benchmark stress factors require different levels of credit enhancement to achieve the same external rating equivalent, the bank must apply the ECAI stress factor that would require the most conservative or highest level of credit protection. For example, if one ECAI required 2.5 to 3.5 times historical losses for an asset type to obtain a single A rating equivalent and another required 2 to 3 times historical losses, the bank must use the higher range of stress factors in determining the appropriate level of seller-provided credit enhancement.
 - A bank cannot utilize an ECAI's rating methodology to derive an internal assessment if the ECAI's process or rating criteria is not publicly available.
- (e) Internal or external auditors, or an ECAI, must perform regular reviews of the internal assessment process and the validity of the internal assessments of the credit quality of the bank's exposures to an ABCP program.
- (f) The bank must track the performance of its internal ratings over time to evaluate the performance of the assigned internal assessments and make adjustments, as necessary, to its assessment process when the performance of the exposures routinely diverges from the assigned internal assessments on those exposures.
- (g) The ABCP program must establish credit and investment guidelines, i.e., underwriting standards, for the ABCP program. In the consideration of an asset purchase, the ABCP program (i.e., the program administrator) should develop an outline of the structure of the purchase transaction. Factors that should be discussed include the type of asset being purchased; type and monetary value of the exposures arising from the provision of liquidity facilities and credit enhancements; loss waterfall; and legal and economic isolation of the transferred assets from the entity selling the assets.
- (h) A credit analysis of the asset seller's risk profile must be performed and should consider, for example, past and expected future financial performance; current market position; expected future competitiveness; leverage, cash flow, and interest coverage; and debt rating. In addition, a review of the seller's underwriting standards, servicing capabilities, and collection processes should be performed.
- (i) The ABCP program's underwriting policy must establish minimum asset eligibility criteria that, among other things,
- excludes the purchase of assets that are significantly past due or defaulted;
 - limits excess concentration to individual obligor or geographic area; and
 - limits the tenor of the assets to be purchased.
- (j) The ABCP program should have collections processes established that consider the operational capability and credit quality of the servicer. The program should mitigate to the extent possible seller/servicer risk through various methods, such as triggers based on current credit quality that would preclude co-mingling of funds and impose lockbox arrangements that would help ensure the continuity of payments to the ABCP program.

- (k) The aggregated estimate of loss on an asset pool that the ABCP program is considering purchasing must consider all sources of potential risk, such as credit and dilution risk. If the seller-provided credit enhancement is sized based on only credit-related losses, then a separate reserve should be established for dilution risk, if dilution risk is material for the particular exposure pool. In addition, in sizing the required enhancement level, the program should review several years of historical information, including losses, delinquencies, dilutions, and the turnover rate of the receivables. Furthermore, the ABCP program should evaluate the characteristics of the underlying asset pool, e.g., weighted average credit score, identify any concentrations to an individual obligor or geographic region, and the granularity of the asset pool.
- (l) The ABCP program must incorporate structural features into the purchase of assets in order to mitigate potential credit deterioration of the underlying portfolio. Such features may include stop-issuance triggers that immediately cease the issuance of commercial paper to the market or wind down triggers.
- (m) The notional amount of the liquidity facility or credit enhancement must be assigned to the risk weight in the RBA appropriate to the credit rating equivalent assigned to the sponsoring bank's exposure.
- (n) If a bank's internal assessment process is no longer considered adequate, the bank's supervisor may preclude the bank from applying the internal assessment approach to its ABCP exposures, both existing and new originated, for determining the appropriate capital treatment until the bank has remedied the deficiencies. In this instance, the bank must revert to the Simplified SF or, if not available, to the fallback option described in CP3.

Description of the Calculation of the Capital Requirement

ABCP programme exposures

A bank is able to use its internal assessments of the credit quality of the exposures the bank extends to ABCP programmes, i.e., liquidity facilities and credit enhancements, if the bank's internal assessment process meets the operational requirements in Section 1 above. Internal assessments of exposures provided to ABCP programs must be mapped to equivalent external ratings of an ECAI. Those rating equivalents are to be used to determine the appropriate risk weights under the RBA for purposes of assigning the notional amounts of the exposures.