

**Memorandum**

**To:** Clients & Friends

**From:** Cadwalader, Wickersham & Taft LLP

**Date:** January 18, 2004

**Re:** Basel Press Release

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**Overview of Basel Committee Press Release as it Relates to Securitisations**

The Basel Committee on Banking Supervision (the “Committee”) issued a press release on 15 January 2004 that describes in general terms certain modifications that the Committee intends to make to its most recent proposed version of the Basel II capital standards (the “Proposed Accord”). The Committee has stated that the modifications (i) are consistent with the proposal made by the Committee in Madrid last October to revise the capital treatment for expected and unexpected credit losses, and (ii) take into account comments that the Committee has received from market participants with respect to both its October proposal and its third “consultative paper” (“CP3”) on the Proposed Accord. This memorandum summarizes the key elements of this press release as it applies to securitisation transactions.

The Committee has stated that it has decided on, and will shortly publish, revisions to the Proposed Accord necessary to (i) implement a revised version of its proposal made in October (for example, the release states that the cap on the recognition of excess provisions will not be based on Tier 2 capital components, as had been proposed by the Committee in October, but instead will equal a percentage (to be determined) of credit risk-weighted assets) and (ii) reflect certain revisions to the manner in which risk capital will be calculated for securitisation transactions under the Proposed Accord.

The Committee has also (i) stated that it intends to refine the rules for recognising credit risk mitigation techniques in response to industry comments as promptly as possible prior to the implementation of the New Accord and (ii) stated that it plans to undertake a review of counterparty credit risk and trading book issues in coordination with the International Organisation of Securities Commissions (IOSCO).

## **Summary of Decisions Related to Securitisation**

### **Treatment of Unrated Exposures**

The Supervisory Formula (the “SF”) approach described in CP3 was developed to address unrated exposures including those to asset-backed commercial paper (“ABCP”) conduits. The Committee is introducing the following alternatives in lieu of the SF approach contained in CP3, as well as modifications to the calculation of  $K_{IRB}$ , which is the capital charge that would have applied had the assets not been securitised.

#### **1. Introduction of an Internal Assessments Approach**

The Committee has stated that it will introduce an internal assessment approach (the “IAA”) for determining capital charges against unrated liquidity facilities and credit enhancements that banks (including third-party banks) extend to 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 a set of operational standards, banks would derive their internal assessments of such exposures based on rating agency criteria for the asset type purchased by the conduit, including those criteria pertaining to the amount of seller-provided credit enhancement needed to achieve a given rating equivalent. The notional amount of the exposure would then be assigned the risk weight corresponding to the external rating equivalent under the Ratings-Based Approach (“RBA”).

#### **2. Simplification of the Supervisory Formula**

In addition to the introduction of the IAA, the Committee has also stated that it will simplify the SF presented in CP3 to be made available to all unrated exposures (including liquidity facilities and credit enhancements extended to ABCP conduits). The Simplified SF will be based on four bank-supplied inputs: (1) the capital charge that would be applied had the assets not been securitised ( $K_{IRB}$ , 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); and (4) the effective number of exposures in the securitised 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-given-default amounts (“LGDs”). Accordingly, this will eliminate that average as an input to the Simplified SF. In addition, the Committee has stated that the Simplified SF will be computationally less complex than the formula provided in CP3.

### **3. 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 securitisation exposures subject to the “top-down” 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 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 has stated that it plans to develop operational criteria that will allow banks to rely on their own LGD estimates for securitisation exposures, particularly for exposures to ABCP conduits. The Committee has also said that it recognises 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 Securitisation Framework**

The Committee has stated that it will eliminate differences in the treatment of securitisation exposures held by originators and investors. In CP3, originating banks were required to deduct all positions (whether externally rated or unrated) that fell below the  $K_{IRB}$  threshold. However, the Committee has now indicated that originators will be permitted to recognise external ratings through the equivalent of BB- on positions that fall below the  $K_{IRB}$  boundary. The cap on an originating bank’s maximum capital requirement will remain in place.

#### **Treatment of Rated Securitisation Exposures**

The Committee has stated that it will revise the risk weights applied under the RBA in order to better align those risk weights with the level of risk inherent in securitisation 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. The Committee has said that the RBA will now 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). Under these revisions the concept of “thickness” will no longer be one of the key determinants of the risk weight assigned to highly rated assets; instead, the “seniority” of such tranches will be considered. This change will make lower risk weights available to a broader array of exposures.

**2. Enhance Sensitivity to Risk of Well-Rated Exposures**

In addition to revising the criteria to be applied in determining which assets may be eligible for the lowest risk weights under the RBA (i.e. moving away from a consideration of the thickness of a tranche and towards a consideration of the seniority of the tranche), the Committee has also modified some of the preferential risk weights available under the RBA, as noted below in bold text.

**Alternative RBA Risk Weights**

<b>External Rating (Illustrative)</b>	<b>Risk Weights for Senior Tranches &amp; Eligible IAA</b>	<b>Base Risk Weights</b>	<b>Risk Weights for Tranches Backed by Non-Granular Pools</b>
Aaa	7%	12%	20%
Aa	<b>8%</b>	15%	25%
A1	<b>10%</b>	<b>18%</b>	35%
A2	<b>12%</b>	<b>20%</b>	35%
A3	<b>20%</b>	<b>35%</b>	35%
Baa1	<b>35%</b>	50%	50%
Baa2	<b>60%</b>	75%	75%
Baa3	100%	100%	100%
Ba1	250%	250%	250%
Ba2	425%	425%	425%
Ba3	650%	650%	650%
Below Ba3 and unrated	Deduction	Deduction	Deduction

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

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credit events has 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 decided to not provide different RBA risk weights for ABS and MBS backed by different underlying asset types.

If you have any questions regarding the Committee's January 15 press release or the status of the Proposed Accord generally please contact either Jim Croke of Cadwalader's London office at +44 20 7170 8758 or Peter Manbeck of Cadwalader's New York office at 212 504 6626.