

## FUND FINANCE FRIDAY

## Capital Idea? Risk-Based Capital, Capital Relief Trades and the Proposed Basel III Endgame Capital Rules

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On July 27, 2023, the U.S. federal prudential bank regulators (the [Federal Deposit Insurance Corporation](#), the [Federal Reserve Board](#) (“FRB”) and the [Office of the Comptroller of the Currency](#)) proposed new capital requirements for large banking organizations. The FRB also proposed to make certain adjustments to the G-SIB surcharge. Over the last week, we’ve received a number of inquiries from banks and buy-side clients about this proposal – in particular, about its effect on banks’ risk-based capital, including for fund finance transactions, and capital optimization strategies, such as capital relief trades and synthetic securitizations. Here are some key takeaways in that regard:

- **Overview.** The proposal would effectively replace the internal models-based “advanced” approach for determining risk-based capital with a new framework designed to be simpler and more consistent with the existing standardized approach framework. The proposed new framework is referred to as the “expanded risk-based approach.”
- **Scope.** The proposal only applies to “large banking organizations” – *i.e.*, banking organizations with total assets of \$100 billion or more and their subsidiary depository institutions.
- **Dual Stack Calculation Requirement.** The replacement of the advanced approach with the proposed expanded risk-based approach would not eliminate the requirement for large

banking organizations to calculate capital twice. Large banking organizations would still need to calculate their capital requirements under both the standardized approach and the proposed expanded risk-based approach, and use whichever method yields a higher capital requirement. Because large banking organizations include banks that were not previously subject to the advanced approach, the proposal would expand the number of institutions subject to this type of a “dual-stack” capital calculation.

- **Timing.** The proposal is expected to take effect over a three-year phase-in period, beginning in mid-2025.
- **Risk-Weights.** Risk-weights for most exposure types would be determined differently under the proposal. For example, under existing U.S. capital regulations, performing “corporate exposures” are generally assigned a 100% risk-weight. Under the proposal, corporate exposures to “investment grade” companies that have publicly traded securities outstanding (or that are controlled by companies that have publicly traded securities outstanding) may be assigned a 65% risk-weight. Other corporate exposures would be risk-weighted differently: qualifying central counterparties would receive a 2-4% risk-weight, project finance exposures would receive a 130% risk-weight, subordinate debt and covered debt instruments would (with certain exceptions) receive a 150% risk-weight, and all other corporate exposures – including those that finance income-producing assets or projects that engage in non-real estate activities where the borrower has no independent ability to repay the loan – would receive a 100% risk-weight. Ultimately, whether any particular exposure’s risk-weight would change under the proposal is a facts-and-circumstances determination. However, we note that the risk-weights for some corporate exposures, such as most capital call loans, are unlikely to change under the proposal (*i.e.*, such exposures would continue to receive a 100% risk-weight).
- **Credit Conversion Factors.** Credit conversion factors (“CCFs”) – which can reduce the risk-based capital for unfunded loan commitments and other off-balance sheet items – would also change. Under the existing capital framework, unconditionally cancellable commitments are assigned a 0% CCF, commitments of less than one year that are not unconditionally cancellable are assigned a 20% CCF, and commitments of one year or more that are not unconditionally cancellable are assigned a 50% CCF. Under the proposal, unconditionally cancellable commitments would be assigned a 20% CCF, and all commitments that are not unconditionally cancellable would be assigned a 40% CCF. These changes are particularly relevant for banks with large portfolios of revolving corporate loan facilities and revolving capital call (subscription finance) loan facilities: uncommitted facilities, which currently receive a 0% CCF, would be assigned an increased CCF of 10% under the proposal, whereas committed facilities, which currently receive a 20% or 50% CCF (depending on the duration of the commitment), would be assigned a 40% CCF under the proposal (whether this is an improvement from the current capital treatment will depend on the duration of the commitment).
- **Operational Criteria for Synthetic Securitizations.** The proposal would add three new operational criteria for synthetic securitizations; any tranching capital relief trade that utilizes credit default swaps, financial guarantees or credit-linked notes would need to satisfy these additional operational criteria. The first of these new criteria would generally bar early amortization provisions in transactions where the synthetically securitized reference exposures are comprised of revolving assets. The second would prohibit synthetic

securitizations from containing synthetic excess spread provisions. And the third would require a minimum payment threshold that is consistent with standard market practice.

- **Securitization Standardized Approach.** The proposal sets out a new formula for risk-weighting securitization tranches – the Securitization Standardized Approach (“SEC-SA”). The SEC-SA is substantively similar to the SSFA (*i.e.*, the formula used by standardized approach banks under the existing capital rules for assigning risk-weights to securitization exposures), with a few noteworthy changes, including: supervisory parameter  $p$  has increased from 0.5 to 1.0, the supervisory risk-weight floor for senior securitization exposures has been reduced from 20% to 15%, and variable  $K_g$  – which represents the weighed-average total capital of the securitized exposures – must take into account the risk-weight attributable to collateral held by SPV-issued credit-linked note structures. Based on our back-of-the-envelope calculations, the SEC-SA would require thicker tranche sizes for traditional and synthetic securitization structures to achieve the same RWA benefits as are currently afforded under the SSFA.
- **Restructuring.** Under the existing capital rules, the effective notional amount of an eligible credit derivative is reduced by 40% if the credit derivative does not contain restructuring as a credit event. Under the proposal, this requirement would not apply if both (i) the terms of the reference loan allow the maturity, principal, coupon, currency or seniority status to be amended outside of receivership, insolvency, liquidation or similar proceeding only by unanimous consent of all parties, and (ii) the bank has conducted sufficient legal review to conclude with a well-founded basis (and maintains sufficient written documentation of that legal review) that the reference loan is subject to the U.S. Bankruptcy Code or a similar domestic or foreign insolvency regime.

If you have any questions about how this proposal affects your bank’s regulatory capital or your capital relief trades, please don’t hesitate to reach out to Cadwalader’s [Basel III Endgame Taskforce](#).

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