



# BASEL II: US BANK-SPONSORED ABCP CONDUITS – INTERNAL RATINGS BASED APPROACH

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# INTERNAL RATINGS BASED APPROACH (IRB)

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Banks Applying the IRB Approach Have Three Potential Options for Determining Capital for ABCP Securitization Exposures:

- Ratings Based Approach (RBA)
- Internal Assessment Approach (IAA)
- Supervisory Formula Approach (SFA)

# APPROACH HIERARCHY

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The hierarchy of approaches that banks with exposures to ABCP conduits should use is:

1. Use RBA if applicable.
  - a. Use qualifying external ratings if available.
  - b. Use an eligible inferred rating if external ratings not available.
2. Use IAA if available.
3. Use SFA.
4. Deduct the nominal exposure from capital if capital cannot be determined using any of the three foregoing methods.

# RATINGS BASED APPROACH AND USE OF INFERRED RATINGS

Three Items Need to be Known to Use the Charts:

- The explicit or inferred rating of the position.
- The granularity of the “pool” (effective number of exposures in the pool (N)).\*
- The seniority of the position.
- Column 2 (most favorable) of the charts is used if N is 6 or more and the position has the most senior claim on the assets in the securitized pool.
- Column 4 (least favorable) is used if N is less than 6.
- Column 3 (standard) is used in all other cases.

\*For retail exposures, N is assumed to be six or more if the number of underlying exposures is 25 or more. Otherwise, the bank must compute N as it does under SFA (see below).

# RATINGS BASED APPROACH AND USE OF INFERRED RATINGS (Cont'd)

Beginning December 31, 2010, a fourth item will need to be known:

- The structure of the position, i.e., whether the exposure is a “resecuritization exposure.”

“A resecuritization exposure is a securitization exposure in which the risk associated with an underlying pool of exposures is tranced and at least one of the underlying exposures is a securitization exposure. In addition, an exposure to one or more resecuritization exposures is a resecuritization exposure.”

- A senior resecuritization exposure must satisfy the following conditions:
  - (1) the exposure is a senior position; and
  - (2) none of the underlying exposures are resecuritization exposures

## ABS RISK WEIGHTS WHEN THE EXTERNAL ASSESSMENT REPRESENTS A LONG-TERM CREDIT RATING AND/OR AN INFERRED RATING DERIVED FROM A LONG-TERM ASSESSMENT

### COLUMNS

<u>1</u> External Rating (Illustrative)	<u>2</u> Risk weights for senior positions backed by granular pools	<u>3</u> Base risk weights	<u>4</u> Risk weight for tranches backed by non-granular pools	<u>5</u> Risk weight for senior resecuritization exposures	<u>6</u> Risk weight for non-senior resecuritization exposures
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 BB- and unrated	Deduction	Deduction	Deduction	Deduction	Deduction

## ABS RISK WEIGHTS WHEN THE EXTERNAL ASSESSMENT REPRESENTS A SHORT-TERM CREDIT RATING AND/OR AN INFERRED RATING DERIVED FROM A SHORT-TERM ASSESSMENT

### COLUMNS

<u>1</u> External Rating (Illustrative)	<u>2</u> Risk weights for senior positions backed by granular pools	<u>3</u> Base risk weights	<u>4</u> Risk weight for tranches backed by non-granular pools	<u>5</u> Risk weight for senior resecuritization exposures	<u>6</u> Risk weight for non-senior resecuritization exposures
A-1/P-1	7%	12%	20%	20%	30%
A-2/P-2	12%	20%	35%	40%	65%
A-3/P-3	60%	75%	75%	150%	225%
All other ratings/unrated	Deduction	Deduction	Deduction	Deduction	Deduction

# USE OF INFERRED RATINGS

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Inferred ratings may be used to calculate capital if ALL of the following requirements are met:

1. There is an externally rated subordinated position (reference position) to the position for which a rating may be inferred.
2. The reference position is subordinate in all respects to the unrated position.
3. The reference position must not benefit from a credit enhancement that is not available to the unrated position.
4. The maturity of the reference position is equal to or longer than the maturity of the unrated position.
5. The reference position rating would be a qualifying external rating.
6. The reference position rating is continuously updated.

If ALL these requirements are met, the inferred rating on the unrated position is the same as the rating on the reference position - EVEN THOUGH THE REFERENCE POSITION IS A SUBORDINATE POSITION TO THE UNRATED POSITION.

# INTERNAL ASSESSMENT APPROACH

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- Only available for securitization exposures to ABCP conduits that have an internal rating equivalent of investment grade or better at inception of the exposure.
- The ABCP of the conduit must be externally rated.
- The risk weight is a function of the internal credit rating, the seniority of the position and its granularity (6 or more exposures is considered granular).
- The bank's internal ratings must be based on publicly available rating agency criteria for the applicable asset class and must rate the exposure at least the equivalent of investment grade.

## DEFINITION OF SECURITIZATION EXPOSURE COULD EXCLUDE CERTAIN TRADITIONAL ABCP CONDUIT TRANSACTIONS

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- Securitization Exposure definition requires that “all or substantially all of the exposures are financial exposures.”
- Auto lease transactions and other transactions that provide funding against residuals might not be “securitization exposures” under this definition.
- Note also that “securitization exposures” do not include transactions the underlying exposures of which are owned by an “operating company” – therefore, ABLs cannot be treated as securitization exposures.

# OPERATIONAL REQUIREMENTS TO USE IAA

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- To use IAA, banks must obtain their regulator's prior approval. To obtain the approval, the bank must demonstrate that its internal assessment process meets the operational requirements set forth in the Final Rule. Among these requirements:
- Internal assessments must be based on publicly available rating agency criteria and must correspond to external ratings categories. If different rating agencies rating the ABCP use different stress factors for determining required reserves for an asset class, the most conservative stress factors must be applied.
- The requirement that rating criteria be publicly available is to be interpreted broadly to encompass not only published criteria, but also criteria that are obtained through communication with rating agencies.
- These communications should be documented and available for review by the bank's supervisor.
- The bank's internal credit assessment process must be at least as conservative as the most conservative of the publicly available rating criteria for the rating agencies rating the ABCP conduit's commercial paper.

## OPERATIONAL REQUIREMENTS TO USE IAA (Cont'd)

- Internal assessments must be used by banks for internal risk management purposes.
- Regular audits of the internal assessment process and the validity of internal assessments must be performed by an independent internal credit review or risk function external auditors.
- The conduit must have robust credit and investment policies in place.
- A detailed credit analysis of the asset seller's credit risk should be performed.
- Minimum asset eligibility criteria must be established that among other things:
  - a. Exclude the purchase of assets significantly past due or defaulted.
  - b. Limit excess obligor or geographic concentration.
  - c. Limit the tenor or assets purchased.

## OPERATIONAL REQUIREMENTS TO USE IAA (Cont'd)

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- The aggregate assessment of loss must include all sources of potential risk, such as credit and dilution risk.
- Where relevant, transactions must incorporate structural features (winddown triggers, stop issuance tests) to mitigate against deterioration of underlying asset pools.
- If a supervisor determines that a bank's internal assessment process is no longer adequate, it can suspend application of IAA until deficiencies are remedied.

## RISK WEIGHTS UNDER IAA

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- Under IAA, after an external rating equivalent is determined, the notional amount of the exposure is assigned a risk weight corresponding to the position's seniority and granularity and the external rating equivalent using the RBA risk weights (see slides 6 and 7).

# SUPERVISORY FORMULA APPROACH

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## Step One: Calculate “KIRB”

KIRB is a fraction equal to:

The on-balance sheet capital charge for the underlying pool of receivables if not securitized (i.e. were on the bank’s balance sheet)

OVER:

The notional amount of the pool receivables (including the exposure at default of any undrawn commitments that may increase the size of the pool receivables)

If KIRB cannot be calculated, the entire securitization exposure is deducted from capital.

## SUPERVISORY FORMULA APPROACH (cont'd)

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### **Step Two: Deduct the Securitization Exposure from Capital to the Extent that $L + T$ is Less Than or Equal to KIRB**

- L** = The percentage of all exposures in the pool represented by all exposures subordinated to the bank's exposure.
- T** = The nominal size of the bank's exposure expressed as a percentage of all exposures in the pool.

# SUPERVISORY FORMULA APPROACH (cont'd)

## Step Three: If SFA is Used, Capital is Calculated Using Five Inputs Determined by the Bank

- KIRB had the exposures not been securitized.
- Degree of credit enhancement supporting the position (L).
- Thickness of position (T).
- Number of effective exposures in the pool (N).\*
- The pool's exposure-weighted average loss-given-default (LGD).
- These inputs are then used in a complicated formula to calculate capital for the exposures.

\*N is a formula representing the “effective” number of exposures rather than a “gross” number of exposures in order to assess the diversification of pools with exposures of different sizes.

# IRB MAXIMUM CAPITAL CHARGE

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- The maximum capital charge under IRB is limited to the capital charge that would apply if the securitized exposures were on the bank's balance sheet.

# IF CAPITAL CANNOT BE CALCULATED UNDER RBA, IAA OR SFA

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- The nominal exposure must be deducted from capital.

## MAJOR POINT:

UNDER IRB THE CREDIT CALCULATION FACTOR THE SAME FOR UNDRAWN LIQUIDITY FACILITIES AS IT IS FOR FUNDED AND CREDIT ENHANCEMENT EXPOSURES

- In general, the Credit Conversion Factor (CCF) is 100% for eligible liquidity facilities under the IRB Approach. Therefore, they attract the same level of capital as other bank securitization exposures with the same credit quality, granularity and seniority.
- Banks using the IRB approach may therefore provide multi-year liquidity facilities and “structured liquidity” without incurring additional capital charges.

# DEFINITION OF “AMOUNT” OF LIQUIDITY EXPOSURE

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- Notional amount of an exposure that takes the form of a commitment (such as liquidity) can be reduced to the maximum amount the bank is required to fund given the current amount of assets in the program (calculated without regard to current credit quality of assets).
- Unused liquidity commitments not supported by assets do not attract capital.

# SENIORITY OF LIQUIDITY EXPOSURES

- The Final Rule for the US IRB approach provides that priority claims on cash flows in the form of fees due, payments due under interest rate or derivative contracts and similar payments do not prevent a liquidity exposure from being “senior.”
- In addition, the Final Rule provides that ABCP and a liquidity facility that supports the ABCP program may both be senior if they are payable on a parity basis.
- Basel II was amended July 2009 to clarify that a liquidity facility will be viewed as covering all losses exceeding the amount of over-collateralization or reserves and as being most senior if it is sized to cover all outstanding CP 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 are repaid in full.
- MOST CURRENT LIQUIDITY FACILITIES WILL NOT BE SENIOR UNDER THIS DEFINITION. Servicing fees and derivative payments, for example, are normally paid before the liquidity is repaid.

# OVERLAPPING EXPOSURES

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- Where a bank has two overlapping exposures to the same transaction, the overlapping portion of the two exposures is assigned the higher of the two capital charges applicable to the separate exposures.
- Relevant example for ABCP conduits is the liquidity facilities provided by the sponsor to individual transactions and the program-wide credit enhancement for the conduit.

# IMPLEMENTING IRB-OVERALL STEPS FOR BANK

1. Bank adopts implementation plan (core banks must adopt within six months of effective date – opt-in banks may adopt at any time).
2. Bank submits plan to supervisor for approval.
3. Parallel run of at least four quarters must be completed to satisfaction of supervisor.
4. Three one-year transitional floor periods then apply before full implementation:

Transitional Floor Period	Transitional Floor Percentage
First Year . . . . .	95
Second Year . . . . .	90
Third Year . . . . .	85

During the floor periods, the bank’s aggregate risked-based capital can be no less than the total Basel I capital charges multiplied by the applicable Transitional Floor Percentage.

# THE FATE OF PROGRAM-WIDE CREDIT ENHANCEMENT

- As discussed above, capital treatment of liquidity facilities under IRB does not depend on whether or not these facilities cover “defaulted assets” or, alternatively, whether sufficient transaction overcollateralization exists to cover “defaulted assets.” Therefore, an ABCP conduit could in theory be structured using only “fully supported” liquidity facilities and no program-wide credit enhancement.
- In general, PWCE is structured to a “BBB-” ratings level, but would not qualify as a senior exposure. Therefore, the risk-based capital for PWCE would equal 8% (100% RW x 8% capital) of the nominal amount of the PWCE (same capital levels as today).

# THE FATE OF PROGRAM-WIDE CREDIT ENHANCEMENT (Cont'd)

- There would therefore be some capital savings in structuring only fully supported transactions without PWCE. As an example, assuming a granular “AA” credit quality trade receivables structure (with senior liquidity), capital for a fully supported transaction would be 64 bps, as compared to 137.6 bps (assuming a 10% PWCE allocation to the transaction)

1. NO PWCE

Capital = 8% RW x 8% Base Capital = 64 bps of RBC

2. PWCE

Capital = Liquidity Capital - (8% RW x 8% Base Capital x

90% of Exposure = 57.6 bps of RBC) *plus* PWCE Capital

= (100% RW x 8% Base Capital x 10% of Exposure = 80

bps of RBC) = 137.6 bps of Total RBC

\* Beginning December 31, 2010, PWCE sized to cover only some of the outstanding ABCP would generally be considered a <sup>26</sup> securitization exposure and a higher risk weight would apply (in the above example, a 225% RW would apply)

# THE FATE OF PROGRAM-WIDE CREDIT ENHANCEMENT (Cont'd)

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- Note, however, that some large investors have indicated that a fully supported conduit would be treated differently for purposes of their exposure limits (i.e. a fully-supported conduit might be treated as a bank exposure by these investors). Sponsors should weigh the potential capital savings of creating fully supported conduits against the possible decrease in investor demand for CP (note that presumably having some (more) fully supported transactions within the conduit would not create this issue).

# TOTAL RISK-BASED CAPITAL (UNRATED TRANSACTIONS)

<u>Credit Quality</u>	<u>Allocation of PWCE</u>	<u>No Allocation of PWCE</u>	<u>Current Rules</u>
AAA	130.4 bps	56.0 bps	152.0 bps
AA	137.6 bps	64.0 bps	
A+	152.0 bps	80.0 bps	
A	166.4 bps	96.0 bps	
A-	224.0 bps	160.0 bps	

(Chart assumes a granular pool, senior liquidity, and that the newly proposed resecuritization risk weights do not apply to the exposures)

(Chart also assumes 10%, BBB- credit quality PWCE)

# DEAL TENOR

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- Under IAA, capital doesn't vary by tenor of liquidity facility commitment.
- Tenor will be dictated by credit standards, competitive forces and other internal bank risk management issues.

# PREPARING FOR IAA

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- Sponsors must apply rating methodologies that map to rating agency methodologies for the relevant asset class.
- Regulator must approve the bank's internal assessment process, methodology and procedures.
- "Robust" credit and investment policy must be in place for the conduit.

# CONDUIT SPONSOR TO DO LIST

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## 1. Prepare for IAA

- Adopt rating methodologies.
- Adopt internal auditing procedures.
- Establish credit and investment policies that contain required eligibility criteria, collection procedures and transaction structural features.
- Obtain regulatory approval.
- Determine if all exposures fit within IAA.

## 2. Assess effects of BIS II on current transaction capital.

## 3. Establish conduit v. on-balance sheet v. third party financing funding strategies.

## 4. Determine investor receptivity to fully-supported conduit.

## 5. Understand capital differences amongst various customer funding options – securitization v. unsecured loan v. secured loan.

## OPEN ISSUES

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1. Will there be further changes to the capital rules in light of current market conditions?
2. Will the U.S. adopt resecuritization and liquidity facility seniority amendments to Basel II wholesale (European Commission has already proposed amendments regarding the resecuritization concept that vary from the amended Basel II language, defining a resecuritization as a securitization where one or more of the underlying exposures meet the definition of a resecuritization position)?
3. Treasury indicated that it may increase capital requirements outside of the BIS framework (September 2009).

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