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Client Alert

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Unfunded Commitments And Letters Of Credit Under The New "Basel III" US Capital Rules

The US banking regulators have issued final Basel III-related capital rules. For *advanced approaches banks* (generally those owned by bank holding companies with $250 billion or more in total assets or $10 billion or more in foreign assets) the new rules affect the treatment of unfunded commitments and letters of credit under both (1) a new supplementary leverage ratio test that measures capital against on- and off-balance sheet assets and (2) a revised risk-based capital framework. *Non-advanced approaches banks* will be affected by a new risk-based capital "standardized approach" that will replace the existing US "general risk-based capital rules" derived from the original 1988 Basel Accord ("Basel I"). As with existing capital rules, the new rules will apply to banks and to their holding companies on a consolidated basis.

The new supplementary leverage ratio and the revised advanced approaches for risk-based capital do not distinguish between letters of credit and loan or liquidity commitments. All such obligations are simply treated as "off-balance sheet exposures." The advanced approaches impose capital requirements on such exposures based on their dollar amount and their risk. The supplementary leverage ratio imposes capital requirements on such exposures based on their dollar amounts (or, in the case of an "unconditionally cancellable commitment," 10% of its dollar amount) without regard to their risk.

The new standardized approach for risk-based capital will continue the existing Basel I special treatment for letters of credit and other "contingent items" that function like letters of credit or guarantees. Traditional corporate loan commitments, liquidity or standby bond purchase agreements supporting municipal bonds or other securities, loan or purchase facilities supporting commercial paper programs, including asset-backed commercial paper programs, and all other forms of bank funding obligations and commitments to a borrower, investor, or other party will be treated as "commitments" unless they are letters of credit or similar guarantees.

Supplementary Leverage Ratio

How will the new supplementary leverage ratio requirement for advanced approaches banks affect commitments and financial guarantees, such as letters of credit?

Advanced approaches banks will need to include the full stated amount of a commitment or letter of credit in computing the "assets" to be covered by Tier 1 capital under this test. They will be required to have Tier 1 capital equal to at least 3% of their "total leverage exposure." A bank's total leverage exposure generally includes the full amount of all on- and off-balance sheet "exposures." "Unconditionally cancellable commitments" will not be included in a bank's total leverage exposure at their full stated amounts, but rather will be included at 10% of their stated (or "notional") amounts. Any funded amount of a commitment will of course be included in "total leverage exposure" as an on-balance sheet asset.

Advanced approaches banks will need to meet the supplementary leverage ratio requirement starting January 1, 2018, but they will need to report the ratio beginning January 1, 2015. The federal banking regulators have already proposed to increase this test to 5% for bank holding companies with $700 billion or more in assets, and to 6% for their subsidiary banks.

Does this mean there is no "credit conversion factor" (CCF) for commitments, letters of credit, and other off-balance sheet exposures included in the supplementary leverage ratio test?

Yes. Although the existing "Basel I" US risk-based capital rules and the new "standardized approach" that takes effect on January 1, 2015, compute the "credit equivalent amount" of an off-balance sheet exposure by applying a "credit conversion factor" (CCF) to the dollar amount of such exposure, there is no CCF for off-balance sheet exposures under the supplementary leverage ratio test (as there is not under either the existing or the revised advanced approaches). In general, the full "notional amount" of each off-balance sheet exposure is treated as part of a bank's "total leverage exposure" for purposes of the supplementary leverage ratio.

The only feature of the supplementary leverage ratio that operates like a CCF for commitments is the special provision for "unconditionally cancellable" commitments, which are included in total leverage exposure at 10% of their "notional amount." A commitment is "unconditionally cancellable" only if the bank can refuse to lend under the commitment at any time for any reason. The full notional amounts of all other commitments are included in a bank's "total leverage exposure."

Credit Conversion Factors (CCFs) Under The New Standardized Approach

Do letters of credit still receive CCFs under the new standardized approach for risk-based capital?

Yes, but (as under current rules) financial guarantee letters of credit and similar obligations receive a 100% CCF. Thus, the full stated amounts of such letters of credit will be treated as assets subject to risk weighting under the new standardized approach. Commercial letters of credit will continue to receive a 20% CCF. Only 20% of their undrawn amount will be risk weighted. Performance letters of credit will continue to receive a 50% CCF. 50% of their undrawn amount will be risk weighted under the new standardized approach.

Do unfunded commitments still receive CCFs under the new standardized approach for risk-based capital?

Yes, but only if the commitments are not "securitization exposures." As described below, certain eligible ABCP liquidity facilities will be able to receive a CCF as securitization exposures.

What are the new CCFs under the standardized approach for commitments that are not securitization exposures?

20% for commitments with an original maturity of one year or less. 50% for commitments longer than one year. This is an increase for short term (one year or less) commitments, which currently have a 0% CCF (i.e., no regulatory capital requirement) under the existing US Basel I risk-based capital rules.

The only type of commitment that will have a 0% CCF when the new standardized approach takes effect on January 1, 2015, will be a commitment that is "unconditionally cancellable by the bank." This means the bank has no meaningful "commitment" because it must be able to refuse to extend credit at any time for any reason (as under the current US Basel I risk-based capital rule).

What is the new treatment for a "commitment to issue a commitment"?

Under the existing US Basel I risk-based capital rules a commitment by a bank to issue a letter of credit is subject to the *higher* of the CCF that would apply to the commitment or the letter of credit, except for a commitment to issue a commercial letter of credit. This means that under existing rules a short-term commitment (currently subject to a 0% CCF) to issue a financial guarantee letter of credit would receive a 100% CCF based on the CCF for the financial guarantee letter of credit.

The new standardized approach will change this treatment by assigning such a commitment the *lower* of the CCF that would apply to the commitment or the letter of credit. Thus, a short term commitment to issue a financial guarantee letter of credit will have a 20% CCF (i.e., only 20% of its undrawn amount will be risk weighted), based on the new 20% CCF for short term commitments. Of course, any financial guarantee letter of credit issued under the commitment will be subject to a 100% CCF and its full stated amount will be risk weighted.

What US banks will use the "standardized approach" so that they can apply these CCFs?

All US banks covered by the new rules will be required to apply the standardized approach. When the new standardized approach takes effect on January 1, 2015, "advanced approaches" banks will compute their regulatory capital requirements under both the "standardized approach" and the "advanced approaches." Those banks will then need to meet the requirements under *both* tests because they will report compliance based on the *lower* of the two ratios for each test. "Standardized approach" banks (and advanced approaches banks that have not completed their "parallel run" in order to operate under the advanced approaches) will only report compliance under the standardized approach computation.

How does a bank compute the "amount" of a commitment before applying a CCF to that amount?

The standardized approach generally treats a commitment amount as being its "notional amount" (i.e., its stated maximum amount). The same is true for letters of credit. The new "advanced approaches" rule does not change the existing treatment whereby any exposure's "notional amount" is relevant for determining "exposure at default" (EAD) as part of the overall computation of the capital requirement for the exposure under the advanced approaches.

Securitization Exposures

How does a bank compute the "amount" of a commitment supporting a securitization transaction?

Under both the standardized and advanced approaches the "exposure amounts" for commitments and other off-balance sheet "exposures" (including letters of credit) that qualify as "securitization exposures" are their "notional amounts" (subject to a special rule for determining the "notional amount" of a commitment or other off-balance sheet exposure to an ABCP program).

What is this special rule for determining the notional amount of a commitment or other off-balance sheet exposure to an ABCP program?

Both the new standardized and advanced approaches will permit a bank to reduce the "notional amount" of any commitment or other "off-balance sheet exposure" to an "ABCP program" (including a letter of credit) to the amount of funding the program permits under the exposure *based on the current assets in the transaction without regard to their credit quality*. Thus, if a bank issues a commitment or a letter of credit to an ABCP program that is larger than the maximum amount the bank could be required to fund based on the current assets in the program (without regard to their credit quality), the bank will be able to treat the lower maximum potential funding amount as the notional amount of the commitment.

The release adopting the new risk-based capital rule specifically rejected applying this special rule to any commitment or other off-balance sheet exposure to a securitization transaction other than a commitment or other off-balance sheet exposure to an ABCP program.

Why don't CCFs apply under the standardized approach to commitments and other off-balance sheet exposures that are "securitization exposures"?

The new standardized approach will treat "securitization exposures" in much the same manner as the advanced approaches treats securitization exposures. Under both approaches there will be no "credit conversion factor" for commitments, letters of credit, or other off-balance sheet exposures that are "securitization exposures," except for certain "eligible ABCP liquidity facilities." Instead, off-balance sheet exposures that are "securitization exposures" will generally equal their "notional amount." The undrawn portion of this notional amount will then be risk weighted the same as any drawn amount of the commitment or other off-balance sheet exposure in determining risk weighted assets. Thus, except for certain eligible ABCP liquidity facilities, neither the standardized approach nor the advanced approaches will distinguish between whether an "exposure" to a securitization transaction is funded or unfunded.

What is the special CCF for eligible ABCP liquidity facilities?

The new standardized approach will permit a bank to apply a 50% credit conversion factor to an "eligible ABCP liquidity facility" if the bank does not risk weight the exposure using the new "simplified supervisory formula approach" (SSFA).

The SSFA is a simplified version of the supervisory formula approach that permits a bank to compute the risk-weight of a securitization exposure based on the amount of subordination supporting the exposure (A), the thickness of the exposure (D), the weighted average risk-weight under the standardized approach of the assets underlying the securitization (Kg), and the current delinquencies of those assets (W).

A bank will be required to apply the SSFA to a securitization exposure under the standardized approach unless the bank is eligible (and elects) to apply one of two optional "gross-up" approaches. First, if the bank is not subject to the market risk rules it could risk weight the exposure based on the weighted average risk weight of all assets underlying the securitization exposure. Second, if the bank has not (or, more likely, because it is subject to the market risk rules, can not) elect this general gross-up option, it could elect to risk weight the "notional amount" of any individual eligible ABCP liquidity facility at the highest risk weight for any underlying asset in the securitization related to that facility. If a bank applies either of these "gross-up" approaches to an eligible ABCP liquidity facility, it will also be permitted to apply a 50% CCF to the notional amount of that facility.

An "eligible ABCP liquidity facility" is a liquidity facility that supports asset backed commercial paper (i.e., ABCP must be issued in the transaction) with an asset quality test that conditions the funding on supporting assets that are not 90 days or more past due or in default.

Effective Dates

The new supplementary leverage ratio test for advanced approaches banks will become effective January 1, 2018 (with reporting starting January 1, 2015). The new advanced approaches for risk-based capital requirements will become effective on January 1, 2014. The new standardized approach for risk-based capital requirements will become effective (for both standardized and advanced approaches banks) on January 1, 2015.

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