July 3, 2013

Federal Reserve Board Adopts Final Basel III Risk-Based Capital Rule: Initial Thoughts on Securitization Provisions

Yesterday the Board of Governors of the Federal Reserve System adopted a final rule revising its risk-based and leverage capital requirements. The final rule can be found here. The changes to the Advanced Approaches framework will be effective January 1, 2014 and the new Standardized Approach framework will be effective January 1, 2015. While we are still in the process of reviewing the rule and the release (it totals 971 pages), our initial impressions of the securitization sections of the rule are set forth below.

A. Changes in Final Rule

In general, the final rule closely follows the securitization provisions of the proposed rule issued in June of last year. There were only a few significant changes to the rule that affect securitization exposures:

1. **The standardized risk weights for residential mortgage loans remain unchanged from the existing Basel I rules.** The "category 1" and "category 2" classifications set forth in the proposed rule that would have assigned risk weights to residential mortgage loans based on underwriting standards and loan-to-value ratios were not adopted in the final rule. Among the industry's concerns with the proposed categories was the lack of availability of the information necessary to determine whether mortgages in a securitized pool were "category 1" or "category 2" loans for purposes of calculating Kg in determining capital of a securitization exposure using the Simplified Supervisory Formula Approach (SSFA). Under the final rule, first lien, prudently underwritten mortgage loans will continue to carry a 50% risk weight and all other residential mortgage loans that are not in default will carry a 100% risk weight as under Basel I rules.

2. **The definition of resecuritization has been modified to exclude single bond re-REMICs and other securitizations of a single underlying exposure.** The federal banking regulators believe that the increased capital surcharge for resecuritizations (the p factor) was meant to address the risk resulting from retranching multiple securitization exposures.

3. **Parameter W will exclude contractual deferrals of payments of principal or interest on (a) all federally guaranteed student loans and (b) other consumer loans (*including non-federally guaranteed student loans*) provided such payments are deferred pursuant to provisions included in the contract at the time funds are disbursed that provide for deferral periods that are not initiated based on changes to a borrower's creditworthiness.** This exclusion is consistent with OCC guidance issued earlier this year under the market risk rules in response to industry comments.

B. Industry Concerns Not Resolved in Final Rule

The final rule did not address several industry concerns with the securitization provisions of the proposed rule, including the following:

1. **The 1,250% maximum risk weight was not capped at the dollar amount of the relevant securitization exposure.** The industry expressed concern that the 1,250% risk weight assignment described in the proposed rule could require a bank to hold more capital against a securitization exposure than the actual exposure at risk. As a result, commenters requested that the amount of risk-based capital required to be held against a securitization exposure be capped at the dollar amount of the relevant securitization exposure. However, the federal banking regulators decided to retain the 1,250% risk weight "consistent with their overall goals of simplicity and comparability, to provide for comparability in risk-weighted asset amounts for the same exposure across institutions."

2. **A 1,250% risk weight is applied to the relevant securitization exposure when a bank fails to comply with the new due diligence requirements.** The federal banking regulators rejected a request for progressively increasing risk weights based on the severity and duration of due diligence violations, which would have been consistent with the EU capital framework. In comments to the proposed rule, the industry expressed concern that a bank may not be able to meet the due diligence requirements due to the lack of availability of data for some securitization exposures. However, the federal banking regulators believe that requiring the due diligence analysis to be commensurate with the complexity and materiality of the securitization exposure provides "sufficient flexibility to mitigate the potential for undue burden."

3. **The amount of an off-balance sheet commitment that is not made to an ABCP conduit is the notional amount of the exposure and is not reduced to the available asset base.** Under the final rule, the notional amount of a bank's off-balance sheet exposure to an ABCP conduit securitization exposure may be reduced to the maximum potential amount that the bank could be required to fund given the ABCP program's current underlying assets. Commenters argued that the risks associated with an undrawn commitment to a customer securitization transaction are the same regardless of whether the commitment is made directly to the customer's SPE or through an ABCP conduit. The federal banking regulators state that they believe that the requirement to hold risk based capital against the notional amount of a commitment "more accurately reflects the risk of potential draws" and the final rule only provides relief for commitments to ABCP conduits.

4. **Kg for purposes of determining the SSFA has not been made more risk sensitive.** The industry expressed concern that the Kg parameter provided in the proposed rule was not sufficiently risk sensitive and commenters argued that the credit quality of the underlying assets should receive more recognition under the SSFA. However, citing their interest in reducing complexity and aligning capital requirements under the securitization framework with the general requirements for credit exposures under the Standardized Approach, the federal banking regulators are adopting the Kg parameter as proposed.

Interestingly, in their commentary (on pages 369 and 370 of the release), the federal banking regulators discuss the changes in Kg proposed by commenters in the context of cash flow modeling when more simple distinctions between the Kg value of assets could have been made based on the "prime" or "subprime" status of the securitized assets. (See, for example, the definitions of various "higher-risk assets" in the recent FDIC assessment rule and the concept of "prudently underwritten" mortgage loans that afford those loans a 50% risk weight). The federal banking regulators indicate (on page 367 of the release) that they intend to monitor implementation of the SSFA and to consider improvements. As a result, there may be another opportunity to raise this issue.

5. **The minimum risk weight for securitization exposures under both the Standardized Approach and the Advanced Approach is 20%.** This is not a surprise to anyone who has been involved in advocacy efforts with the respect to the rule. While inconsistent with the 7% minimum risk weight that currently applies internationally under the Basel III framework, consistent with the US approach, the Basel Committee on Banking Supervision proposed an increase in the minimum risk weight for securitization exposures to 20% in its December 2012 consultative paper.

6. **Pool-wide inputs may not be used to determine Kirb for purposes of the Supervisory Formula Approach.** This is consistent with the current SFA under the US Basel II rules and the market risk rule. This remains a significant industry concern given the position of the SFA at the top of the hierarchy of approaches under the final rule and the lack of access to the information needed to calculate Kirb for individual securitized exposures in many transactions where the bank is an investor in a securitization transaction.

7. **Securitization exposures in which a small percentage of the underlying exposures constitute securitization exposures are not excluded from the definition of resecuritization.** The industry expressed concern that a small percentage of the underlying exposures of many existing CLOs consist of other securitization exposures (typically, to other CLO transactions) and that to treat the entire amount of such a transaction as a resecuritization overstates the risk of the transaction. To address this concern, commenters requested that the definition of resecuritization be modified to exclude securitizations in which 5% or less of the underlying exposures consititute securitization exposures. The federal banking regulators rejected the request, indicating they believe "the introduction of securitization exposures into a pool of securitized exposures significantly increases the complexity and correlation risk" of the underlying pool.

The FDIC provided notice yesterday that on July 9 it will consider the rule text as an interim final rule. The OCC expects to consider the final rule on or before that date. We will produce a more detailed description and analysis of the final rule in the coming days.

Meanwhile, please feel free to contact Tim Mohan, Rachel George or your usual Chapman and Cutler attorney to discuss any aspect of the rule.

For More Information

For more information on any of the topics covered in this client alert, please contact one of the attorneys above or visit us online at chapman.com.

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