

## TREATMENT OF SECURITIZATIONS UNDER PROPOSED RISK-BASED CAPITAL RULES

In early June 2012, the Board of Governors of the Federal Reserve System (the “FRB”), the Office of the Comptroller of the Currency (the “OCC”) and the Federal Deposit Insurance Corporation (the “FDIC” and collectively with the FRB and OCC, the “Agencies”) proposed an extensive revision of the risk-based capital requirements for U.S. banks.<sup>1</sup> These new rules (the “Proposed Capital Rules”) would significantly amend the capital framework governing both the minimum capital requirements for banks<sup>2</sup> and the risk weighting for specific asset classes. Generally the Proposed Capital Rules would remove the Basel I regulatory framework (the “general capital rules”) and incorporate the Basel III capital standards. The Proposed Capital Rules do have some material differences from the Basel standards, particularly the elimination of using rating agency determinations and ratings for any risk weighting determinations, which was required by Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).

The Proposed Capital Rules consist of three notices of proposed rulemaking (the “Basel III NPR,” the “Standardized Approach NPR” and the “Advanced Approach NPR,” and collectively, the “NPRs”). The Basel III NPR incorporates the Basel III regulatory capital standards to calculate the amount, deductions and adjustments of regulatory capital (i.e., the numerator in the relevant risk-based capital ratio). The remaining NPRs focus on risk weighting for assets (i.e. the denominator in the relevant risk-based capital ratio). The Standardized Approach NPR outlines the standard approach (the “Standardized Approach”) that would apply to most banks and would establish the minimum capital floor for all U.S. banks under the Collins Amendment.<sup>3</sup> The Advanced Approach NPR would modify the risk weighting rules for advanced approaches banks (the “Advanced Approach”) in accordance with Basel III. Comments on the Proposed Capital Rules are due by September 7, 2012.

<sup>1</sup> The FRB released these proposed rules on June 7, 2012, and the OCC and FDIC followed on June 12, 2012.

<sup>2</sup> The Proposed Capital Rules would apply to banks, thrifts, bank holding companies, and thrift holding companies, as specified in each NPR. For simplicity, we refer to all such entities as “banks.”

<sup>3</sup> Section 171 of the Dodd-Frank Act, commonly known as the “Collins Amendment,” provides that banks, bank and thrift holding companies (except for certain small bank holding companies), and systemically important nonbank financial companies must be subject to minimum capital requirements that cannot be less than the “generally applicable risk-based capital rules” established by the Agencies for insured depository institutions. This minimum capital requirement will serve as a floor for any capital requirements that the Agencies may require. In the NPRs, the Agencies stated that the requirements proposed in the Basel III NPR and the Standardized Approach NPR would become the “generally applicable” capital requirements for these purposes, and therefore serve as the capital floor required by the Collins Amendment.

The Agencies also finalized amendments to their market risk capital rules (the “Market Risk Rule”). In accordance with the Basel Accord’s capital adjustments based on market risk (often called “Basel 2.5”) and the Dodd-Frank Act, the Market Risk Rule amends the existing capital rules regarding market risk for banks with significant trading activity.<sup>4</sup>

This client alert focuses on the effect the Proposed Capital Rules would have on the securitization market, if and when they are adopted. The initial sections provide a brief overview of risk weight calculation under the Proposed Capital Rules generally and the specific steps for determining a risk weight for securitization transactions and any related credit risk mitigation. This alert then reviews each step individually, highlighting changes important to the securitization market.

## **EXECUTIVE SUMMARY**

The Proposed Capital Rules would significantly alter a bank’s calculation of risk weights for securitization exposures. These rules would institute two approaches for risk weight calculation. The Standardized Approach would apply to all banks subject to minimum capital requirements while the Advanced Approach would apply to any bank that has consolidated total assets of \$250 billion or more, has consolidated on-balance sheet exposure of \$10 billion or more is a subsidiary of such a bank.

The calculation of risk weights for securitization exposures under the Proposed Capital Rules would generally involve four steps.

1. *Determining “securitization exposure”.* The Proposed Capital Rules provide specific terms for exactly the types of exposures that would constitute securitizations. The main determinant would be that a securitization exposure generally is a transfer of risk of an underlying financial instrument where investors purchase tranching exposure to the risk and receive returns based on the returns on that financial instrument.
2. *Applying operational criteria and due diligence.* After finding a transaction constitutes securitization exposure, specific diligence and operational criteria must be met to receive favorable risk-weighting. The required operational criteria would differ slightly for traditional and synthetic securitizations and some of the new provisions in the Proposed Capital Rules could affect certain common securitization structures.
3. *Risk weight calculation.* Under the Standardized Approach, a bank generally would be required to calculate a risk-weighted asset amount for each

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<sup>4</sup> A bank that is subject to the Market Risk Rule must exclude covered positions, as defined in the Market Risk Rule, from its calculation of risk-weighted assets under the Advanced Approach, and instead calculate its capital charge for these positions under the Market Risk Rule. “Covered positions” generally include short term trading assets and liabilities. If a securitization exposure is a covered position, the adjustments under the Market Risk Rule generally will consider the market liquidity and risk for a position based on current performance of the underlying assets during current and stressed market conditions and other market-related variables. The expected effect is that subordinate and riskier securitization exposures that are covered positions will be subject to higher risk weighting under the Market Risk Rule. This risk weights discussed herein do not incorporate the effects of the Market Risk Rule.

securitization exposure by applying a simplified supervisory approach (“SSFA”) or, for banks that are not subject to the Market Risk Rule, a gross-up approach similar to an approach currently provided under the general capital rules. Under the Advanced Approach, securitizations would generally be subject to either a supervisory formula approach (“SFA”) or the SSFA. Any bank using the Advanced Approach also would be required to calculate the total risk weight of its assets under the Standardized Approach and apply the higher of the two requirements.

4. *Credit Risk Mitigation.* The risk weights potentially could be lowered on a securitization exposure through the use of credit derivatives, guarantees and/or financial collateral meeting the requirements specified in the Proposed Capital Rules.

The Proposed Capital Rules would alter the risk weighting for most securitization exposures, but the breadth of the impact would differ by asset class. Further, as the risk weights for the underlying assets also would be changed, the bank’s relative capital charge for a securitization would change when compared to the cost of retaining the underlying assets, particularly for mortgages and certain corporate exposures.

## **CALCULATION OF RISK-WEIGHTED ASSETS**

Under the NPRs, there would be two approaches for calculating total risk-weighted assets:

- The *Standardized Approach* would now apply to all banks subject to minimum capital requirements. The Standardized Approach would replace the existing general capital rules, which use broad categories to assign risk weights. In particular, the Standardized Approach would apply greater sensitivity and granularity to the measurement of risk for each exposure and the amount of capital a bank must hold against each exposure. The Standardized Approach would be effective January 1, 2015, though a bank could opt to use the approach as of an earlier date.
- The *Advanced Approach* would be required to be used by the largest banks and those banks with significant foreign exposure. Specifically, it would apply to a bank that has consolidated total assets of \$250 billion or more, has consolidated on-balance sheet exposure of \$10 billion or more or a subsidiary of such a bank. These banks are already subject to a version of the Advanced Approach (the “Existing Advanced Approach”). Under the Advanced Approach NPR a bank could continue to calculate the risk weight of certain categories of assets using internal models, but other categories of assets, including securitization exposures, would be subject to specific frameworks, as described in the Advanced Approach NPR. The Advanced Approach NPR did not provide a proposed effective date.

A bank that uses the Advanced Approach also would be required to calculate its total risk-weighted assets under the Standardized Approach, which would be used in determining the minimum capital floor required under the Collins Amendment. These banks would need to hold capital based on the higher of the two requirements as determined under the Advanced Approach and the Standardized Approach.

The changes under the Proposed Capital Rules, including the capital required to be held for securitization exposures, would be dramatic for banks that currently are subject to the general capital rules but would have to apply the Standardized Approach.

Sophisticated banks are already subject to Existing Advanced Approach, but the changes proposed in the NPRs would impose certain important changes for these banks as well. For example, banks using the Advanced Approach would no longer be able to calculate risk weights for securitization exposures using internal assessment or ratings-based approaches.

## **CALCULATING RISK-WEIGHTED ASSETS FOR SECURITIZATION EXPOSURES**

Both the Standardized Approach and the Advanced Approach provide specific frameworks for calculating risk weights for securitization exposures. These frameworks include requirements that securitizations must meet for a bank to benefit from the securitization (*i.e.*, to hold capital only against exposures retained by the bank) and the manner of calculation of risk-weighted assets for the positions retained by the bank. In other words, the Proposed Capital Rules seek a more precise determination of the exact credit risks faced by the bank from a securitization exposure, which results in a heightened need for careful analysis by the bank of each step of the transaction. Minor differences in the type and transfer of the collateral, document structure and counterparties can have a significant effect on the risk weighting for a securitization transaction.

Generally, analysis of a securitization exposure would include the following steps:

1. Determine whether an exposure is a “securitization exposure”;
2. Determine whether the securitization meets the operational criteria and due diligence requirements under the Proposed Capital Rules, which would allow the bank to treat exposures from the securitization (whether or not retained by the bank) under the rules’ framework for securitizations;
3. Calculate the risk weight for retained securitization exposures; and
4. Apply any credit risk mitigation provided through guarantees, credit derivatives or collateral.

The first three steps lead to a determination of a risk weight for a particular securitization, while the fourth step indicates how a bank can reduce such risk weight through the use of a credit derivative, financial collateral or a guarantee.

### **STEP 1: DETERMINING “SECURITIZATION EXPOSURE”**

As under the Existing Advanced Approach, the Proposed Capital Rules would define what it means for an exposure to be a “securitization exposure.” A “securitization exposure” under both the Standardized Approach and the Advanced Approach would be (i) an on- or off-balance sheet credit exposure (including credit-enhancing representations and warranties) that arises from a traditional or synthetic securitization (including a resecuritization), or (ii) an exposure that directly or indirectly references such a securitization exposure.<sup>5</sup> Generally, a “securitization exposure” is any transfer of credit risk from financial exposures to a third party where the third party offers investors

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<sup>5</sup> This definition would be based on the definition of securitization exposure in the Existing Advanced Approach, but would broaden the definition by also including exposures that directly or indirectly reference securitization exposures.

exposure to such credit risk in two or more tranches of different seniority and performance of the securitization exposure depends upon the performance of the underlying financial exposure.

The notes to the Standardized Approach NPR provide that the concept of the underlying financial exposure (*i.e.*, the credit risk being transferred into the securitization) is quite broad, encompassing both financial payment streams as well as less obvious payment streams from lease residuals and entertainment royalties. Most structured finance transactions would be considered securitization exposures, as would a variety of other types of transactions (such as letters of credit, liquidity facilities and credit derivatives) if they have tranching exposure. The Proposed Capital Rules would create a boundary between the securitization framework and the general credit risk framework where the assets backing the loan are typically nonfinancial assets (*e.g.*, tranching project finance loans). It is possible that some types of assets could be the subject of a securitization but still not constitute an underlying financial exposure, either because the securitized asset is not a traditional financial asset (*e.g.*, life settlements or commodities), or because the credit risk transferred encompasses more than a financial asset (*e.g.*, a whole business securitization). The Agencies, however, reserve the right under the Proposed Capital Rules to scope any transaction into the securitization framework based on the economic substance, leverage and risk profile of the transaction.

As under the Existing Advanced Approach, there would be separate categories under the Proposed Capital Rules for “traditional securitization” and “synthetic securitization.” One important change from the current definition of “traditional securitization” under the Existing Advanced Approach would be that certain types of investment firms would be excluded. In addition, a “resecuritization exposure” would be defined under the Proposed Capital Rules as (i) an on- or off-balance sheet exposure to a resecuritization, or (ii) an exposure that directly or indirectly references a resecuritization exposure.

## **STEP 2: SATISFYING OPERATIONAL CRITERIA AND DUE DILIGENCE REQUIREMENTS**

For a bank to treat an exposure as a securitization exposure under either the Standardized Approach or the Advanced Approach, including the ability to exclude securitization exposures not retained by the bank, certain specified operational criteria and due diligence requirements would have to be met. The operational criteria under the Proposed Capital Rules would be based on the operational criteria now required for banks subject to the Existing Advanced Approach, but would be broadened and would now apply to all banks. The due diligence requirements also would create new requirements for all banks.

### **Operational Criteria**

An originating bank that meets the requisite operational criteria could exclude traditional or synthetic securitization exposures transferred to a third party from its total risk-weighted assets calculation. It would be required to hold risk-based capital only against any remaining securitization exposures retained by the bank.

*Traditional securitization.* A bank would satisfy the operational criteria for a traditional securitization if:

1. The exposures are not reported on the bank’s consolidated balance sheet under GAAP;

2. The bank has transferred to one or more third parties credit risk associated with the underlying exposures;
3. Any clean-up calls relating to the securitization are “eligible clean-up calls” (as defined in the Proposed Capital Rules); and
4. The securitization does not (i) include one or more underlying exposures in which the borrower is permitted to vary the drawn amount within an agreed limit under a line of credit, and (ii) contain an early amortization provision.

*Synthetic securitization.* A bank would satisfy the operational criteria for a synthetic securitization if:

1. The credit risk mitigant (i.e., the instrument used to synthetically transfer exposure) is “financial collateral,” an “eligible credit derivative,” or “an eligible guarantee”;
2. The bank transfers credit risk associated with the underlying exposures to one or more third parties, and the terms and conditions in the credit risk mitigants employed do not include certain types of provisions that would limit the credit risk transfer (such as provisions allowing termination of the credit protection due to deterioration in the credit quality of the underlying exposures);
3. The bank obtains a well-reasoned opinion from legal counsel that confirms the enforceability of the credit risk mitigant in all relevant jurisdictions; and
4. Any clean-up calls relating to the securitization are eligible clean-up calls (as defined in the Proposed Capital Rules).

If the relevant operational criteria are not met, the originating bank would be required to (A) hold risk-based capital against the transferred exposures as if they had not been securitized and (B) in the case of a traditional securitization, deduct from common equity tier 1 capital any after-tax gain-on-sale resulting from the securitization transaction.

For the most part, these operational requirements are common parts of securitization transactions, but a few criteria may be problematic. The traditional securitization operational criterion regarding early amortization provision is currently a risk weight factor under the Existing Advanced Approach. It is unclear whether this structural change would affect the Agencies’ interpretation of early amortization provisions contained in many home equity lines of credit (“HELOCs”), credit card and other revolving receivables deals, though it could affect the risk-weighting for such provisions. For synthetic securitizations, limiting termination rights based on a deterioration of the value of the underlying assets could create significant exposure for the bank. This criterion exists under the Existing Advanced Approach, but would now be applied to banks subject to the Standardized Approach. As discussed below, these provisions could force banks to use innovative structures if they are to both retain similar financial protection and obtain securitization treatment for the exposure.

### **Due Diligence Requirements**

The due diligence requirements would require a bank to demonstrate, to the satisfaction of its primary federal supervisor, that it has comprehensive understanding of the features

that would affect the exposure's performance. The bank's analysis of a securitization exposure must be commensurate with the complexity of the securitization exposure and the materiality of the exposure in relation to its capital.

To demonstrate that it has the requisite comprehensive understanding of a securitization exposure, a bank would be required to conduct an analysis of the risk characteristics of a securitization exposure before acquiring the exposure, and document that analysis within three business days after acquiring the exposure. In its analysis, the bank would need to consider structural features of the securitization, relevant information regarding the performance of the underlying credit exposure(s), relevant market data, and, for resecuritization exposures, performance information on the underlying securitization exposures. In addition, on an ongoing basis (but not less than quarterly), the analysis would have to be evaluated, reviewed, and updated, as appropriate. If these due diligence requirements were not met for a securitization exposure and the exposure was not deducted from common tier 1 equity capital, the bank would be required to assign the securitization exposure a risk weight of 1,250%.

The required due diligence provisions would be quite extensive, evidencing the Agencies' desire to identify all possible risks of a securitization exposure. The full scope of the diligence standards (and, therefore, the extent to which they exceed current diligence standards) will not be fully certain until the Proposed Capital Rules become effective. However, the Proposed Capital Rules' detailed requirements for analysis, historical data and a detailed review of risks may be a difficult hurdle for new products (which may not have sufficient historical data) or new entrants into the market (who may not have the resources or experience to satisfy these requirements).

For each quarter, any bank that has \$50 billion or more in total consolidated assets or that is subject to the Advanced Approach would be required to prepare disclosures with broad qualitative and quantitative information regarding its capital structure and risk-weighted assets, including any securitization exposures.<sup>6</sup> The bank would be required to make these disclosures publicly available for the previous three years (or the shorter period beginning when the Proposed Capital Rules become effective).

### **Step 3: Calculation of Risk Weights**

The Standardized Approach and the Advanced Approach would subject banks to specific frameworks for calculating the risk weights for securitization exposures. An originating bank would not be required to hold capital against credit risk from a securitization exposure transferred to a third party. The risk weights discussed below would be used for securitization exposures retained by the originating bank or held by a bank that acquires the securitization exposure.

### **Standardized Approach**

Under the Standardized Approach, a bank generally would be required to calculate a risk-weighted asset amount for each securitization exposure by applying SSFA or, for banks

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<sup>6</sup> The Proposed Capital Rules would provide an exemption from the disclosure requirements for any bank that meets the \$50 billion asset threshold or is an Advanced Approach bank, but is a consolidated subsidiary of a bank holding company, savings and loan holding company or bank that is subject to the disclosure requirements or a subsidiary of a non-U.S. bank that is subject to comparable disclosure requirements in its home jurisdiction.

that are not subject to the Market Risk Rule, a gross-up approach similar to an approach currently provided under the general capital rules.

### ***Exposure Amount for Securitization Exposures***

For an on-balance sheet securitization exposure (other than a repo-style transaction, eligible margin loan, OTC derivative contract or derivative that is a cleared transaction (other than a credit derivative)), the exposure amount under the Standardized Approach would be the carrying value of the exposure. For an off-balance sheet securitization exposure (other than eligible asset-backed commercial paper (“ABCP”) liquidity facility, repo-style transaction, eligible margin loan or derivative that is a cleared transaction (other than a credit derivative)), the exposure amount would be the notional amount of the exposure. For ABCP programs, the Proposed Capital Rules would provide certain adjustments to the securitization exposure amount calculation for off-balance sheet exposures to an ABCP program and eligible ABCP liquidity facilities as described below.

For a securitization exposure that is a repo-style transaction (*i.e.*, a repurchase agreement, reverse repurchase agreement, securities lending transaction or securities borrowing transaction), eligible margin loan or derivative contract (other than a credit derivative), the exposure amount would be the exposure amount of the transaction as calculated under the provisions in the Proposed Capital Rules for OTC derivative contracts or collateralized transactions, as applicable. This exposure amount could differ from the corresponding exposure for a securitization for certain types of transactions and assets, resulting in a lower risk weight for the transaction.

### ***Overview of Approaches***

The following approaches would apply to securitization exposures under the Standardized Approach:

- *Gain on sale and credit-enhancing interest-only strips (“CEIOs”).* A bank would be required to deduct from common equity tier 1 capital any after-tax gain-on-sale resulting from a securitization and apply a 1,250% risk weight to the portion of the CEIO that does not constitute an after-tax gain on sale.
- *SSFA and Gross-Up Approach.* A bank would use the SSFA for securitization exposures (other than CEIOs requiring deduction as described above), or, if the bank is not subject to the Market Risk Rule, it would be permitted to use the gross-up approach. In either case, the bank would be required to apply the selected approach consistently across its securitization exposures.
- *Alternative Approaches.* If the bank cannot or chooses not to apply the SSFA or gross-up approach to a securitization exposure (other than CEIOs as described above), the bank would be required to use a risk weight of 1,250% for the securitization exposure, but the Agencies have provided a few exceptions. For certain eligible ABCP liquidity facilities, the bank would be allowed to instead multiply the exposure amount by the highest risk weight applicable to any of the individual underlying exposures. For a securitization exposure (other than an ABCP liquidity facility) that is in a second loss position or better to an ABCP program and meets certain other criteria, the bank could determine the risk weight by multiplying the exposure amount by the higher of 100% and the highest risk weight applicable to any of the individual underlying exposures of the ABCP program.



The Standardized Approach also would provide rules for specific treatment of certain categories of securitization exposures. Many of these rules are drawn from existing treatment of these categories under the Existing Advanced Approach. Asset categories subject to these special rules would include: derivatives contracts (other than credit derivatives), overlapping exposures, undrawn portions of eligible servicer cash advance facilities, interest-only mortgage backed securities, small-business loans and leases on personal property with retained contractual exposure and nth-to-default credit derivatives.

These proposed specific treatment rules demonstrate the Agencies' focus on precisely identifying the assets that are transferred and the risks that are retained by the bank. This focus also is evident in the Proposed Capital Rules regarding potential recourse against the originating bank. For example, credit-enhancing representations and warranties are representations and warranties with respect to transferred assets whereby the bank is obligated to protect another party from losses due to the credit risk of those assets.<sup>7</sup> If any representation and warranty provides such recourse, it would be a credit-enhancing representation and warranty, and the bank would be treated as having securitization exposure to all assets covered by that recourse as if the bank had provided a guarantee. While this concept exists under the current general capital rules, the Proposed Capital Rules would slightly expand the scope of coverage.

The Proposed Capital Rules also would focus on support ("implicit support") the bank provides for a securitization beyond its contractual obligations. If a bank provides such implicit support, the bank would lose the capital benefit of the securitization. It would be required to (1) include in its risk-weighted assets all of the underlying exposures associated with the securitization as if the exposure had not been securitized, (2) deduct from common tier 1 capital any after-tax gain-on-sale resulting from the securitization and (3) disclose the matter publicly.

### **SSFA**

Under the SSFA, a bank would calculate risk weights for securitization exposures using a formula that starts with a baseline derived from the capital requirements that apply to all exposures underlying a securitization<sup>8</sup> and then assigns risk weights based on the subordination level of an exposure. The SSFA is designed to apply relatively higher capital requirements to the more risky junior tranches of a securitization that are the first to absorb losses and relatively lower requirements to the most senior exposures.

The SSFA formula would use certain inputs to calculate the risk-based capital requirement for the securitization exposure.<sup>9</sup> One of the inputs in the SSFA, the "supervisory calibration parameter" or "p" is higher for resecuritizations, meaning resecuritizations would have higher risk weights than securitizations with similar characteristics.

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<sup>7</sup> Representations allowing the return of the assets for misrepresentation, fraud or incomplete documentation are not credit-enhancing representations and warranties.

<sup>8</sup> For most on-balance sheet securitizations, exposure is the carrying value of the securitization, while for most off-balance securitizations the exposure is the notional amount of the securitization.

<sup>9</sup> The SSFA provisions of the Standardized Approach NPR, which include the specific inputs and the SSFA formula, are provided in Appendix I.

For each securitization, there would be a supervisory risk weight floor of 20%. The SSFA would apply a 1,250% risk weight to securitization exposures that absorb losses up to the amount of capital that would be required for the underlying exposures had those exposures been held directly by a bank.

### **Gross-Up Approach**

Under the gross-up approach, risk-based capital requirements would be assigned based on the full amount of the credit-enhanced assets for which the bank directly or indirectly assumes (or retains) credit risk.

For each securitization exposure, a credit equivalent amount would be calculated by multiplying the sum of the exposure amount and the pro rata share<sup>10</sup> by the enhanced amount.<sup>11</sup> Risk-weighted assets would then be calculated by applying the weighted-average risk weight of underlying exposures in the securitization pool to the credit equivalent amount. As under the SSFA, there would be a supervisory risk weight floor of 20% for each securitization.

### **Advanced Approach**

The Advanced Approach would, consistent with section 939A of the Dodd-Frank Act, remove the ratings-based approach and internal assessment approach from the framework of the Existing Advanced Approach for risk weighting securitization exposures. Securitizations would generally be subject to either the SFA or the SSFA.

### **Exposure Amount for Securitization Exposures**

The exposure amount of a securitization exposure under the Advanced Approach generally would be determined in the same manner as under the Standardized Approach, with certain modifications.

### **Overview of Approaches**

The following approaches would apply to securitization exposures under the Advanced Approach:

- *Gain on sale and CEIOs.* A bank would be required to deduct from common equity tier 1 capital any after-tax gain-on-sale resulting from a securitization<sup>12</sup> and apply a 1,250% risk weight to the portion of the CEIO that does not constitute an after-tax gain on sale.
- *SFA.* A bank would be required to use the SFA for securitization exposures (other than CEIOs requiring deduction as described above) except where data is not available to calculate the SFA.
- *SSFA.* If the bank cannot apply the SFA because not all the relevant qualification criteria are met, it would be allowed to apply the SSFA. A bank should be able to

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<sup>10</sup> The “pro rata share” would be the par value of the bank’s securitization exposure as a percent of the par value of the tranche in which the securitization exposure resides.

<sup>11</sup> The “enhanced amount” would be the value of tranches that are more senior to the tranche in which the bank’s securitization resides

<sup>12</sup> Under the Advanced Approach, a bank may calculate any deduction from common tier 1 equity capital for a securitization exposure net of any deferred tax liability associated with the exposure.

explain and justify (*e.g.*, based on data availability) to its primary federal supervisor any instances in which the bank uses the SSFA rather than the SFA for its securitization exposures.

- *1,250% risk weight.* If the bank cannot apply the SFA or the SSFA to the exposure, the bank would be required to assign a 1,250% risk weight.

Similar to the Existing Advanced Approach, the proposed Advanced Approach would provide rules for specific treatment of certain categories of securitization exposures. Most of these specific rules are similar to those under the Standardized Approach, with certain adjustments as appropriate for application of the SFA. The Advanced Approach also would provide approaches for risk weights of securitizations of non-internal ratings-based exposures (*i.e.*, securitizations where any underlying exposure is not a wholesale exposure, retail exposure, securitization exposure or equity exposure). In such cases, an originating bank would be required to deduct from common equity tier 1 capital any after-tax gain-on-sale resulting from the securitization and apply a 1,250% risk weight to the portion of any CEIO that does not constitute gain-on-sale.

## SFA

As under the Existing Advanced Approach, the SFA formula would be used to calculate risk-weighted amounts based on certain specific inputs.<sup>13</sup> The risk-weighted amount for each securitization exposure would be equal to the risk-based capital requirement for the exposure multiplied by 12.5

## Maximum Risk-Based Capital Treatment

As under the Existing Advanced Approach, the Proposed Capital Rules would include a mechanism to generally prevent a bank's effective risk-based capital requirement from increasing as a result of the bank securitizing its assets. A bank's effective risk-based capital treatment for all of its securitization exposures to a single securitization would be limited to the applicable risk-based capital requirement if the underlying exposures were held by the bank plus the total expected credit loss ("ECL") of the underlying exposures.

## STEP 4: CREDIT RISK MITIGATION

Under both the Standardized Approach and the Advanced Approach, banks may be able to benefit from credit risk mitigation provided through eligible guarantees, eligible credit derivatives or financial collateral.

### Credit Mitigation Through Guarantees and Credit Derivatives

A bank would only be permitted to recognize an "eligible guarantee" or "eligible credit derivative" provided by an "eligible guarantor" in determining the bank's risk-weighted asset amount for a securitization exposure. These eligibility criteria would be similar to those under the Existing Advanced Approach with a few notable exceptions. A broader array of parties could be used as eligible guarantors, including any entity (other than a monoline) (i) that has outstanding investment grade debt and (ii) with a credit risk that is not positively correlated with the credit risk of the exposure(s) for which it is providing a guarantee. The definitions of "eligible guarantee" and "eligible credit derivative" each contain specific terms and coverage that would need to be included for the bank to receive the credit risk mitigation benefits.

<sup>13</sup> The SFA provisions of the Advanced Approach NPR, which include the specifics inputs and the SSFA formula, are provided in Appendix II.

## Benefit from Eligible Guarantees and Eligible Credit Derivatives

The Standardized Approach and the Advanced Approach would provide specific frameworks for recognizing the credit mitigation benefits to securitization exposures from eligible guarantees and eligible credit derivatives. In both cases, the benefit would result from application of the credit risk of the guarantor or credit derivative provider to the securitization exposure.

*Standardized Approach (Substitution Approach).* If the protection amount of an eligible guarantee or eligible credit derivative is greater than or equal to the exposure amount of the hedged exposure, a bank would substitute the risk weight applicable to the guarantor or credit derivative provider for the risk weight assigned to the hedged exposure. Where only partial protection is provided, a bank would treat the hedged exposure as two separate exposures (protected and unprotected) and recognize the credit risk mitigation benefit of the guarantee or credit derivative on the protected exposure.

*Advanced Approach.* If the protection amount of the eligible guarantee or eligible credit derivative equals or exceeds the amount of the securitization exposure, the bank would be permitted to set the risk-weighted asset amount for the securitization exposure equal to the risk-weighted asset amount for a direct exposure to the eligible guarantor, as determined using the appropriate parameters under the Advanced Approach. Similar to the Standardized Approach, if the protection amount of an eligible guarantee or eligible credit derivative is less than the amount of the securitization exposure, the bank would treat the hedged exposure as two separate exposures (protected and unprotected) to recognize the credit risk mitigation benefit of the guarantee or credit derivative.<sup>14</sup>

Under both approaches, the benefit from the eligible guarantee or eligible credit derivative would be subject to haircuts or adjustments for maturity mismatches, credit derivatives where restructuring is not a credit event and currency mismatches. In the context of a synthetic securitization, when an eligible guarantee or eligible credit derivative covers multiple hedged exposures that have different residual maturities, the bank would be required to use the longest residual maturity of any of the hedged exposures as the residual maturity of all the hedged exposures.

## Credit Mitigation Through Financial Collateral

A bank may only recognize benefits of “financial collateral” in determining the bank’s risk-weighted asset amount for a securitization exposure.

### Financial Collateral

The definition of “financial collateral” under both the Standardized Approach and the Advanced Approach would be based on the definition of “collateral” under the Existing

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<sup>14</sup> When a bank using the Advanced Approach recognizes an eligible guarantee or eligible credit derivative provided by an eligible guarantor in determining the bank’s risk-weighted asset amount for a securitization exposure, the bank would also be required to (1) calculate ECL for the protected portion of the exposure using the same risk parameters that it uses for calculating the risk-weighted asset amount of the exposure and (2) add the exposure’s ECL to the bank’s total ECL.

Advanced Approach, but with two important modifications. First, consistent with Basel III, resecuritizations would no longer qualify as financial collateral. Second, conforming residential mortgages would not qualify as financial collateral.

As proposed, financial collateral would be the collateral in the form of:

- Cash on deposit with the bank (including cash held for the bank by a third-party custodian or trustee);
- Gold bullion;
- Short- and long-term debt securities that are not resecuritization exposures and that are investment grade;
- Equity securities that are publicly traded;
- Convertible bonds that are publicly traded; or
- Money market fund shares and other mutual fund shares if a price for the shares is publicly quoted daily.

With the exception of cash on deposit, the bank would also be required to have perfected, first-priority interest or, outside of the United States, the legal equivalent thereof, notwithstanding the prior security interest of any custodial agent.

In addition, as set forth in the Standardized Approach NPR, a bank would be required to meet certain due diligence and other requirements before recognizing financial collateral for credit risk mitigation purposes.

### **Benefit from Financial Collateral**

The Standardized Approach and the Advanced Approach would provide specific frameworks for recognizing the credit mitigation benefits to securitization exposures from financial collateral.

*Standardized Approach.* For banks subject to the Standardized Approach, a “simple approach” would be used for financial collateral that secures any exposure if (a) the collateral is subject to a collateral agreement for at least the life of the exposure, (b) the collateral must be revalued at least every six months, and (c) the collateral (other than gold) and the exposure are denominated in the same currency. Similar to the existing general capital rules, the collateralized portion of the exposure would receive the risk weight applicable to the collateral. The risk weight assigned to the collateralized portion of the exposure would be no less than 20%, subject to exceptions for certain exposures for which the collateralized portion could be assigned a lower risk weight (such as an exposure secured by cash). The unsecured portion of exposure would be assigned a risk weight based on the risk weight assigned to the exposure under the Proposed Capital Rules.

A “collateral haircut approach” could be used to recognize the credit risk mitigation benefits of financial collateral that secures an eligible margin loan, repo-style transaction or collateralized derivative contract (or secured obligations pursuant to a netting agreement relating to sets of one of such transactions). A bank using the collateral haircut approach could use standard supervisory haircuts or, with prior written approval of its primary federal supervisor, its own estimates of haircuts.

A bank would be allowed to use any of the approaches that are permitted for a particular type of exposure or transaction, but it would be required to use the same approach for all of its similar exposures or transactions.

*Advanced Approach.* A bank subject to the Advanced Approach would be able to recognize financial collateral in determining the bank's risk-weighted asset amount for a securitization exposure, with the exception of repo-style transactions, eligible margin loans or OTC derivative contracts for which the bank has reflected collateral in its determination of the applicable exposure amount. The bank's risk-weighted asset amount for the collateralized securitization exposure would be the risk weight amount for the securitization exposure, as calculated under the SSFA or SFA, as adjusted to reflect the collateral following application of a haircut. A bank would use either standard supervisory haircuts or, with prior written approval from its primary federal supervisor, its own estimates of haircuts.

## **Effect on Specific Types of Securitization**

The steps outlined above specify the procedure for calculating a risk weight for a particular securitization transaction. It is important to highlight the likely effects of the proposed new risk weights across common securitization types and asset classes. The gravity of the effect of the Proposed Capital Rules on the securitization market will differ depending on the asset class. Some of the Proposed Capital Rules specifically limit or hinder particular types of securitization. Also, the risk weightings of different types of assets and securitizations would change in a non-uniform matter. Therefore, the relative cost of securitizations (as compared to continuing to hold the underlying asset) would be different for certain asset classes.<sup>15</sup>

- *Credit Card Receivables, HELOCs and Other Revolving Credit Facilities.* While the risk weight for receivables would, to a large extent, remain unchanged, the Proposed Capital Rules may require modification of various traditional securitization structures. The organizational criteria contain requirements for an originating bank to be able to exclude securitized assets from its capital calculations. Among other things, a securitization transaction would not meet the organizational criteria where (i) the borrower on the underlying asset can vary the drawn amount, and (ii) the deal contains an early amortization<sup>16</sup> provision based on decreased performance of the assets (or a decline in excess spread. The Agencies note in the Standardized NPR that their concern relates to revolving credit facilities included as part of a securitization where the bank retains either exposure to funding future draws or other payments or losses after an early amortization event. While similar early amortization language is contained in Basel II

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<sup>15</sup> The descriptions below focus on the Standardized Approach terms and, where applicable, reference material differences applicable to the Advanced Approach.

<sup>16</sup> The precise definition would provide that an "early amortization provision" would not meet the operational criteria if it is "a provision in the documentation governing a securitization that, when triggered, causes investors in the securitization exposures to be repaid before the original stated maturity of the securitization exposures, unless the provision: (1) is triggered solely by events not directly related to the performance of the underlying exposures or the originating bank (such as material changes in tax laws or regulations); or (2) leaves investors fully exposed to future draws by borrowers on the underlying exposures even after the provision is triggered."

and a specific risk-weighting category in the Existing Advanced Approach,<sup>17</sup> the resulting risk weight may be higher under the Proposed Capital Rules and it is unclear whether transferring this provision to operational criteria indicates the Agencies' intent to alter their interpretation of early amortization provisions.

- *Residential Mortgages.* The clearest example of a relative risk weight change for an underlying asset is in residential mortgages. Under the general capital rules, risk weighting for mortgages on one to four family ("Small Residential") properties, pre-sold Small Residential construction loans and mortgages on multifamily residential ("Large Residential") properties ranges from 50% to 100%. Under the Proposed Capital Rules, pre-sold Small Residential construction loans and Large Residential mortgages would have a 50% risk weighting solely if they meet certain express guidelines. Otherwise, the risk weighting would be 100%.

Small Residential mortgages would be divided into two separate categories based on the credit and payment terms. Within these categories, different risk weights would be provided based on the loan-to-value ("LTV") ratio of the borrower (as is done under the Existing Advanced Approach). The resulting risk weighting under the Proposed Capital Rules could vary from 35% to 200%, with Category I ranging from 35% to 100% and Category II ranging from 100% to 200%. Depending on the makeup of a mortgage portfolio, the cost of retaining the portfolio under the Proposed Capital Rules could change relative to the cost of a securitization.

Other changes to mortgage risk weighting could alter the typical composition of securitized portfolios and the capital structure of transactions. Unlike the general capital rules, a restructuring of a mortgage would not automatically lead to a higher risk weighting for the mortgage; rather, such restructured mortgage would be reviewed as with any other mortgage, based on its terms and LTV ratio. For certain government restructuring programs, the modification would be treated as having not occurred at all. Also, the risk weighting of CEIOs (1,250%) may alter the typical capital structure for a mortgage-backed securitization. CEIOs are more common in second lien and subprime mortgage deals however, so this larger required capital charge may not be as burdensome when compared to the benefits of selling such riskier (and therefore likely higher risk-weighted) mortgages. Any interest-only strip that is not considered credit-enhancing would have a risk weight of 100%. Finally, a revision to the risk-weighting of certain mortgage servicing assets may affect the relative cost of a securitization transaction.

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<sup>17</sup> With respect to early amortization provisions, Basel II contains explicit exceptions for (i) securitizations with a replenishment structure where individual underlying exposures do not revolve and early amortization ends the bank's ability to add new underlying exposures to the securitization, (ii) securitizations of revolving assets where the amortization features do not transfer the risk of the underlying exposures back to the bank, and (iii) securitizations where investors remain fully exposed to future draws on the underlying exposures even after the occurrence of an early amortization. The Proposed Capital Rules only include clause (ii) of these limitations. The early amortization definition in the Existing Advanced Approach is similar to the Proposed Capital Rules definition except (i) the language would now be part of organizational criteria under the Proposed Capital Rules rather than just an addition to risk-weight and (ii) the Existing Advanced Approach contains exceptions limiting the risk weight for certain early amortization structures.

- *Commercial Mortgages.* Currently, under the general capital rules commercial real estate exposures receive a 100% risk weight. The Proposed Capital Rules provide that certain commercial real estate exposures (“High Volatility Commercial Real Estate Exposures” or “HVCRES”) would be risk-weighted at 150%. A credit facility financing the acquisition, development or construction (“ADC”) of commercial property would be an HVCRES unless (i) the LTV ratio is less than the Agencies’ maximum supervisory LTV in the applicable rating standards, (ii) prior to advances under the credit facility, the borrower contributed liquid capital of at least 15% of the real estate’s appraised “as completed value,” and (iii) the capital provided by the borrower (or internally generated by the project) is contractually required to remain in the project until the credit facility is sold, replaced with permanent financing or paid in full. Commercial real estate exposures that are not HVCRES would retain a 100% risk weight. As with the adjustments in residential mortgage risk weights, the total cost of holding onto a portfolio of HVCRES under the Proposed Capital Rules may change relative to the cost of a securitization.
- *Past-Due Loans.* Under the general capital rules, a loan being past-due generally does not alter the risk weight for the loan. In accordance with the Basel Accord, the Proposed Capital Rules would provide that any non-sovereign unguaranteed and unsecured exposure that is past-due for 90 or more days or on non-accrual status would receive a 150% risk weighting. In residential mortgages, any Small Residential mortgage that is 90 or more days past-due or on non-accrual status would automatically be placed in Category 2 and therefore have a risk weighting ranging from 100% to 200% based on LTV ratio.
- *ABCP.* Under the Proposed Capital Rules, a bank with securitization exposure to ABCP (such as pursuant to an ABCP liquidity facility) generally would be required to hold capital against (i) if the ABCP is on-balance sheet, the carrying value of the ABCP facility (similar to all other on-balance sheet securitizations), and (ii) if the ABCP facility is off-balance sheet, the maximum amount the bank could be required to fund based on the current underlying assets. The exposure amount of an eligible ABCP liquidity facility that is subject to the SSFA would be the notional amount of the exposure multiplied by a 50% credit conversion factor (“CCF”). The exposure amount of an eligible ABCP liquidity facility that is not subject to the SSFA would be the notional amount of the exposure multiplied by a 100% CCF. Similar to treatment of other assets, the ABCP facility risk weighting would be significantly lower if the ABCP facility is prohibited from holding underlying assets that are 90 or more days past-due (*i.e.*, this prohibition is the requirement for the facility to be an “eligible” ABCP facility).

Further, exposure to an ABCP program would be a resecuritization exposure (and thus be subject to higher risk weighting) unless: (i) the program-wide credit enhancement does not meet the definition of a resecuritization exposure; or (ii) the entity sponsoring the program fully supports the commercial paper through the provision of liquidity so that the commercial paper holders effectively are exposed to the default risk of the sponsor instead of the underlying exposures (*i.e.*, the ABCP sponsor guarantees any loss beyond the first-loss overcollateralization provided by the underlying asset sellers).

- *Other Assets and Potential Disparities.* The risk weight for most other assets generally would stay the same as under the current general capital rules. The revisions to calculations under the Advanced Approach may alter the actual risk weights currently applied by individual banks for particular assets; in particular, the significant limitations



on using a bank's internal assessment approach ("IAA") could lead to a marked change for the risk weights currently applicable to banks accustomed to using the IAA.

While many of the risk weights in the Proposed Capital Rules match the terms of the applicable Basel Accord, this is not universally true. There may be opportunities for banks to transfer assets or undertake securitizations or other transactions to take advantage of the disparities among Basel, the Proposed Capital Rules and the corresponding capital rules adopted by other countries. One area of particular difference is the Proposed Capital Rules' elimination of ratings-based criteria as required by the Dodd-Frank Act, whereas the Basel Accord and the corresponding legislation in other countries still incorporate ratings as part of the risk weight analysis.

- *Synthetic Securitizations and Derivatives.* The Proposed Capital Rules may also increase the relative cost of synthetic securitizations. The operational criteria for a synthetic securitizations are similar to those for traditional securitizations, with a few changes relating to the derivative structure. One requirement would prohibit termination of credit protection due to deterioration of the credit quality of the underlying portfolio. Currently, some synthetic deals provide certain termination rights if the underlying exposures fell below a certain level. Under the Proposed Capital Rules, the swap likely would need to be structured differently to retain similar financial protection for the bank.

The Proposed Capital Rules also identify specific terms for derivatives in a securitization transaction. If a securitization exposure is an OTC derivative contract or derivative contract that is a cleared transaction (other than a credit derivative) that has first priority claim on the cash flows from the underlying exposures (notwithstanding amounts due under interest rate or currency derivative contracts, fees due or other similar payments), a bank could, with approval of its primary federal supervisor, choose to set the risk-weighted asset amount of the exposure equal to the exposure amount. Similar to many recent regulations and laws, derivative contracts that are cleared through a central counterparty generally are given lower risk weights than comparable OTC derivative contracts. Credit derivatives used as part of a synthetic securitization are analyzed as part of the securitization exposure analysis, while credit derivatives that are used for purposes of minimizing credit risk are dealt with as part of the credit risk mitigation determination.

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## APPENDIX I

### SSFA CALCULATION UNDER PROPOSED CAPITAL RULES

The following information is an extract of the Proposed Capital Rules published by the FRB on June 7, 2012 governing the specific SSFA calculations.

(a) General requirements. To use the SSFA to determine the risk weight for a securitization exposure, a [BANK] must have data that enables it to assign accurately the parameters described in § \_\_.43(b). Data used to assign the parameters described in § \_\_.43(b) must be the most currently available data and no more than 91 calendar days old. A [BANK] that does not have the appropriate data to assign the parameters described in § \_\_.43(b) must assign a risk weight of 1,250 percent to the exposure.

(b) SSFA parameters. To calculate the risk weight for a securitization exposure using the SSFA, a [BANK] must have accurate information on the following five inputs to the SSFA calculation:

(1)  $K_G$  is the weighted-average (with unpaid principal used as the weight for each exposure) total capital requirement of the underlying exposures calculated using this subpart.  $K_G$  is expressed as a decimal value between zero and 1 (that is, an average risk weight of 100 percent represents a value of  $K_G$  equal to .08).

(2) Parameter W is expressed as a decimal value between zero and one. Parameter W is the ratio of the sum of the dollar amounts of any underlying exposures within the securitized pool that meet any of the criteria as set forth in §§ \_\_.43(b)(2)(i) through (vi) to the ending balance, measured in dollars, of underlying exposures:

- (i) Ninety days or more past due,
- (ii) Subject to a bankruptcy or insolvency proceeding,
- (iii) In the process of foreclosure,
- (iv) Held as real estate owned;
- (v) Has contractually deferred interest payments for 90 days or more; or
- (vi) Is in default.

(3) Parameter A is the attachment point for the exposure, which represents the threshold at which credit losses will first be allocated to the exposure. Parameter A equals the ratio of the current dollar amount of underlying exposures that are subordinated to the exposure of the [BANK] to the current dollar amount of underlying exposures. Any reserve account funded by the accumulated cash flows from the underlying exposures that is subordinated to the [BANK]'s securitization exposure may be included in the calculation of parameter A to the extent that cash is present in the account. Parameter A is expressed as a decimal value between zero and one.

(4) Parameter D is the detachment point for the exposure, which represents the threshold at which credit losses of principal allocated to the exposure would result in a total loss of principal. Parameter D equals parameter A plus the ratio of the current dollar amount of the securitization exposures that are pari passu with the exposure (that is, have equal seniority with respect to credit risk) to the current dollar amount of the underlying exposures. Parameter D is expressed as a decimal value between zero and one.

(5) A supervisory calibration parameter,  $p$ , is equal to 0.5 for securitization exposures that are not resecuritization exposures and equal to 1.5 for resecuritization exposures.

(c) Mechanics of the SSFA.  $K_G$  and  $W$  are used to calculate  $K_A$ , the augmented value of  $K_G$ , which reflects the observed credit quality of the underlying pool of exposures.  $K_A$  is defined in § \_\_\_\_.43(d). The values of parameters  $A$  and  $D$ , relative to  $K_A$  determine the risk weight assigned to a securitization exposure as described in § \_\_\_\_.43(d). The risk weight assigned to a securitization exposure, or portion of an exposure, as appropriate, is the larger of the risk weight determined in accordance with this § \_\_\_\_.43(c) and § \_\_\_\_.43(d) and a risk weight of 20 percent.

(1) When the detachment point, parameter  $D$ , for a securitization exposure is less than or equal to  $K_A$ , the exposure must be assigned a risk weight of 1,250 percent.

(2) When the attachment point, parameter  $A$ , for a securitization exposure is greater than or equal to  $K_A$ , the [BANK] must calculate the risk weight in accordance with § \_\_\_\_.43(d).

(3) When  $A$  is less than  $K_A$  and  $D$  is greater than  $K_A$ , the risk weight is a weighted-average of 1,250 percent and 1,250 percent times  $K_{SSFA}$  calculated in accordance with § \_\_\_\_.43(d), but with the parameter  $A$  revised to be set equal to  $K_A$ . For the purpose of this weighted-average calculation:

- (i) The weight assigned to 1,250 percent equals  $\frac{K_A - A}{D - A}$ .
- (ii) The weight assigned to 1,250 percent times  $K_{SSFA}$  equals  $\frac{D - K_A}{D - A}$ .
- (iii) The risk weight will be set equal to:

$$RW = \left[ \left( \frac{K_A - A}{D - A} \right) \times 1,250 \text{ percent} \right] + \left[ \left( \frac{D - K_A}{D - A} \right) \times 1,250 \text{ percent} \times K_{SSFA} \right]$$

(d) SSFA equation. (1) The [BANK] must define the following parameters:

$$K_A = (1 - W) \cdot K_G + (.5 \cdot W)$$

$$a = -\frac{1}{p \cdot K_A}$$

$$u = D - K_A$$

$$l = A - K_A$$

$e = 2.71828$ , the base of the natural logarithms.

(2) Then the [BANK] must calculate  $K_{SSFA}$  according to the following equation:

$$K_{SSFA} = \frac{e^{a \cdot u} - e^{a \cdot l}}{a(u-l)}$$

(3) The risk weight for the exposure (expressed as a percent) is equal to  $K_{SSFA} \times 1,250$ .

**APPENDIX II**  
**SFA CALCULATION UNDER PROPOSED CAPITAL RULES**

The following information is an extract of the Proposed Capital Rules published by the FRB on June 7, 2012 governing the specific SFA calculations.

(a) Eligibility requirements. A [BANK] must use the SFA to determine its risk-weighted asset amount for a securitization exposure if the [BANK] can calculate on an ongoing basis each of the SFA parameters in § \_\_\_.143(e).

(b) Mechanics. The risk-weighted asset amount for the securitization exposure equals the SFA risk-based capital requirement for the exposure multiplied by 12.5.

(c) The SFA risk-based capital requirement. (1) If  $K_{IRB}$  is greater than or equal to  $L+T$ , the capital requirement equals the exposure amount.

(2) If  $K_{IRB}$  is less than or equal to  $L$ , the exposure's SFA risk-based capital requirement is  $UE$  multiplied by  $TP$  multiplied by the greater of:

- (i)  $F \times T$  (where  $F$  is 0.016 for all securitization exposures); or
- (ii)  $S[L + T] - S[L]$ .

(3) If  $K_{IRB}$  is greater than  $L$  and less than  $L + T$ , the [BANK] must apply a 1,250 percent risk weight to an amount equal to  $UE * TP * (K_{IRB} - L)$ , and the exposure's SFA risk-based capital requirement is  $UE$  multiplied by  $TP$  multiplied by the greater of:

- (i)  $F \times (T - (K_{IRB} - L))$  (where  $F$  is 0.016 for all other securitization exposures); or
- (ii)  $S[L + T] - S[K_{IRB}]$ .

(d) The supervisory formula:

$$(1) S[Y] = \begin{cases} Y & \text{when } Y \leq K_{IRB} \\ K_{IRB} + K[Y] - K[K_{IRB}] + \frac{d \cdot K_{IRB}}{20} \left(1 - e^{\frac{20(K_{IRB} - Y)}{K_{IRB}}}\right) & \text{when } Y > K_{IRB} \end{cases}$$

$$(2) K[Y] = (1 - h) \cdot [(1 - \beta[Y; a, b]) \cdot Y + \beta[Y; a + 1, b] \cdot c]$$

$$(3) h = \left(1 - \frac{K_{IRB}}{EWALGD}\right)^N$$

$$(4) a = g \cdot c$$

$$(5) b = g \cdot (1 - c)$$

$$(6) c = \frac{K_{IRB}}{1 - h}$$

$$(7) g = \frac{(1 - c) \cdot c}{f} - 1$$

$$(8) f = \frac{v + K_{IRB}^2}{1 - h} - c^2 + \frac{(1 - K_{IRB}) \cdot K_{IRB} - v}{(1 - h) \cdot 1000}$$

$$(9) v = K_{IRB} \cdot \frac{(EWALGD - K_{IRB}) + .25 \cdot (1 - EWALGD)}{N}$$

$$(10) d = 1 - (1 - h) \cdot (1 - \beta[K_{IRB}; a, b]).$$

(11) In these expressions,  $\beta [Y; a, b]$  refers to the cumulative beta distribution with parameters a and b evaluated at Y. In the case where  $N = 1$  and  $EWALGD = 100$  percent,  $S[Y]$  in formula (1) must be calculated with  $K[Y]$  set equal to the product of  $K_{IRB}$  and Y, and d set equal to  $1 - K_{IRB}$ .

(e) SFA parameters. (1) Amount of the underlying exposures (UE). UE is the EAD of any underlying exposures that are wholesale and retail exposures (including the amount of any funded spread accounts, cash collateral accounts, and other similar funded credit enhancements) plus the amount of any underlying exposures that are securitization exposures (as defined in § \_\_.142(e)) plus the adjusted carrying value of any underlying exposures that are equity exposures (as defined in § \_\_.151(b)).

(2) Tranche percentage (TP). TP is the ratio of the amount of the [BANK]'s securitization exposure to the amount of the tranche that contains the securitization exposure.

(3) Capital requirement on underlying exposures ( $K_{IRB}$ )

(i)  $K_{IRB}$  is the ratio of:

(A) The sum of the risk-based capital requirements for the underlying exposures plus the expected credit losses of the underlying exposures (as determined under this subpart E as if the underlying exposures were directly held by the [BANK]); to

(B) UE.

(ii) The calculation of  $K_{IRB}$  must reflect the effects of any credit risk mitigant applied to the underlying exposures (either to an individual underlying exposure, to a group of underlying exposures, or to the entire pool of underlying exposures).

(iii) All assets related to the securitization are treated as underlying exposures, including assets in a reserve account (such as a cash collateral account).

(4) Credit enhancement level (L). (i) L is the ratio of:

(A) The amount of all securitization exposures subordinated to the tranche that contains the [BANK]'s securitization exposure; to

(B) UE.

(ii) A [BANK] must determine L before considering the effects of any tranche-specific credit enhancements.

(iii) Any gain-on-sale or CEIO associated with the securitization may not be included in L.

(iv) Any reserve account funded by accumulated cash flows from the underlying exposures that is subordinated to the tranche that contains the [BANK]'s securitization exposure may be included in the numerator and denominator of L to the extent cash has accumulated in the account. Unfunded reserve accounts (that is, reserve accounts that are to be funded from future cash flows from the underlying exposures) may not be included in the calculation of L.

(v) In some cases, the purchase price of receivables will reflect a discount that provides credit enhancement (for example, first loss protection) for all or certain tranches of the securitization. When this arises, L should be calculated inclusive of this discount if the discount provides credit enhancement for the securitization exposure.

(5) Thickness of tranche (T). T is the ratio of:

(i) The amount of the tranche that contains the [BANK]'s securitization exposure; to

(ii) UE.

(6) Effective number of exposures (N). (i) Unless the [BANK] elects to use the formula provided in § \_\_.143(f),

$$N = \frac{(\sum_i EAD_i)^2}{\sum_i EAD_i^2}$$

where  $EAD_i$  represents the EAD associated with the  $i^{\text{th}}$  instrument in the pool of underlying exposures.

(ii) Multiple exposures to one obligor must be treated as a single underlying exposure.

(iii) In the case of a re-securitization, the [BANK] must treat each underlying exposure as a single underlying exposure and must not look through to the originally securitized underlying exposures.

(7) Exposure-weighted average loss given default (EWALGD). EWALGD is calculated as:

$$EWALGD = \frac{\sum_i LGD_i \cdot EAD_i}{\sum_i EAD_i}$$

where  $LGD_i$  represents the average LGD associated with all exposures to the  $i^{\text{th}}$  obligor. In the case of a re-securitization, an LGD of 100 percent must be assumed for the underlying exposures that are themselves securitization exposures.

(f) Simplified method for computing N and EWALGD. (1) If all underlying exposures of a securitization are retail exposures, a [BANK] may apply the SFA using the following simplifications:

(i)  $h = 0$ ; and

(ii)  $v = 0$ .

(2) Under the conditions in sections 143(f)(3) and (f)(4), a [BANK] may employ a simplified method for calculating N and EWALGD.

(3) If  $C_1$  is no more than 0.03, a [BANK] may set  $EWALGD = 0.50$  if none of the underlying exposures is a securitization exposure, or may set  $EWALGD = 1$  if one or more of the underlying exposures is a securitization exposure, and may set N equal to the following amount:

$$N = \frac{1}{C_1 C_m + \left( \frac{C_m - C_1}{m - 1} \right) \max(1 - m C_1, 0)}$$

where:

(i)  $C_m$  is the ratio of the sum of the amounts of the 'm' largest underlying exposures to UE; and

(ii) The level of m is to be selected by the [BANK].

(4) Alternatively, if only  $C_1$  is available and  $C_1$  is no more than 0.03, the [BANK] may set  $EWALGD = 0.50$  if none of the underlying exposures is a securitization exposure, or may set  $EWALGD = 1$  if one or more of the underlying exposures is a securitization exposure and may set  $N = 1/C_1$ .

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