FEDERAL RESERVE BANK OF SAN FRANCISCO
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BANKING SUPERVISION AND REGULATION:
SECURITIZATION CAPITAL RULE

To State Member Banks, Bank
Holding Companies, U.S. Branches
and Agencies of Foreign Banks,
and Others Concerned,
in the Twelfth Federal Reserve District

Risk-Based Capital Treatment for Unrated Direct Credit Substitutes Extended to Asset-Backed Commercial Paper Programs (SR 05-6)

On November 29, 2001, the Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Office of Thrift Supervision (the "Agencies") amended their risk-based capital standards by adopting a new capital framework for banking organizations engaged in securitization activities ("Securitization Capital Rule" or the "Rule").[1] The attached interagency guidance clarifies how banking organizations are to use internal ratings that they assign to asset pools purchased by their asset-backed commercial paper (ABCP) programs in order to risk weight appropriately any direct credit substitutes, e.g., guarantees, extended to such programs.

The attached guidance provides an analytical framework for assessing the broad risk characteristics of direct credit substitutes that a banking organization provides to an ABCP program it sponsors and provides specific information on evaluating direct credit substitutes issued in the form of program-wide credit enhancements. In almost all cases, externally rated commercial paper issued out of an ABCP program is supported by program-wide credit enhancement. Often sponsoring banking organizations provide, in whole or in part, program-wide credit enhancement to their ABCP programs, which may take a number of different forms, including an irrevocable loan facility, standby letter of credit, financial guarantee, or subordinated debt.

The Securitization Capital Rule permits a banking organization with a qualifying internal risk rating system to use that system to apply the internal ratings approach to its unrated direct credit substitutes provided to ABCP programs that it sponsors by mapping its internal risk ratings to external ratings equivalents.[2] The external credit rating equivalents are organized into three ratings categories: investment grade credit risk, e.g., BBB- and above, high non-investment grade credit risk, e.g., BB+ through BB-, and low non-investment grade credit risk, e.g., below BB-. The rating categories are used to determine the appropriate risk-weight category or categories to which banking organizations should assign either the entire notional amount, or portions thereof, of their direct credit substitutes.

The minimum risk weight available under the internal risk ratings approach is 100 percent for an investment grade exposure, even if the direct credit substitute is highly rated internally, e.g., AAA.[3] Direct credit substitutes internally rated high non-investment grade would be assigned to the 200 percent risk weight, whereas those internally rated more than one category below investment grade (e.g., BB-) would receive the "gross-up" treatment. That is, the banking organization extending the direct credit substitute must maintain capital against the notional amount of this position plus all more senior positions, subject to the low-level exposure rule.[4] Application of "gross-up" treatment, in many cases, will result in an effective dollar-for-dollar capital charge on direct credit substitutes that fall into the low non-investment grade category.

The guidance introduces the “weakest link” approach for calculating the risk-based capital requirement applicable to a program-wide credit enhancement. This approach assumes that the risk of the program-wide credit enhancement is directly dependent on the quality, i.e., internal rating, of the riskiest asset pools purchased by the ABCP program. The weakest link concept assumes that the probability that the program-wide credit enhancement will be drawn is equal to the probability of default of the asset pools with the weakest internal risk rating. Thus, in accordance with current market practice, the weakest link approach requires banking organization to internally rate its risk exposure to every asset pool purchased by its ABCP programs and use those internal ratings to assign the notional amount of the program-wide credit enhancement to risk weight categories, as appropriate.

The weakest link approach assigns risk-based capital against the program-wide credit enhancement in rank order of the internal ratings starting with the lowest internally rated asset pools supported by the program-wide credit enhancement. Accordingly, if all of the positions supported by the program-wide credit enhancement are internally rated investment grade, then sponsoring banking organizations would risk-weight the notional amount of their program-wide credit enhancements at 100 percent. or asset pools supported by the program-wide credit enhancement that are non-investment grade, banking organizations would have to maintain higher amounts of risk-based capital.

The use of internal risk ratings under the Securitization Capital Rule is limited to determining the risk-based capital charge for unrated direct credit substitutes that banking organizations provide to ABCP programs. Thus, banking organizations may not utilize the internal ratings approach to derive the risk-based capital requirement for unrated direct credit substitutes extended to other transactions.[5]

Additional Information

All circulars and documents are available on the Internet through the Federal Reserve Bank of San Francisco’s Internet site, at http://www.frbsf.org/banking/letters.

For additional information about the Securitization Capital Rule, please contact our Banking Supervision and Regulation Department at (415) 974-2225.

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Attachment: *Supervisory guidance to assist in the determination of the appropriate risk-based capital treatment to be applied to direct credit substitutes issued in connection with asset-backed commercial paper programs*

Notes:

[1] See 66 Fed. Reg. 59614 (November 29, 2001). See also 12 CFR Part 3, appendix A, Section 4 (OCC); 12 CFR Parts 208 and 225, appendix A, Section III.B.3 (FRB); 12 CFR Part 325, appendix A, Section II.B.5 (FDIC); and 12 CFR Section 567.6(b) (OTS).

[2] ABCP programs include multi-seller ABCP conduits, credit arbitrage ABCP conduits, and structured investment vehicles.

[3] Exposures externally rated by a nationally recognized statistical rating organization (NRSRO) above BBB+ are eligible for lower risk weights (e.g., 20 percent for AAA and AA, 50 percent for A).

[4] “Gross-up” treatment means that a position is combined with all of the more senior positions in the transaction. The resulting credit equivalent amount is then risk-weighted based on the obligor or, if relevant, the guarantor or the nature of the collateral. The low-level exposure rule provides that the dollar amount of risk-based capital required for a recourse obligation or direct credit substitute should not exceed the maximum dollar amount for which a banking organization is contractually liable.

[5] Approved use of the internal ratings-based approach for ABCP programs under the Securitization Capital Rule will have no bearing on the overall appropriateness of a banking organization’s internal risk rating system for purposes of the advanced internal ratings-based approach set forth in the Basel II Capital Accord.