

What Effects Will Basel II Have on the Global ABCP Market?

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Basel II Could Affect Banks'
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Standard & Poor's Ratings Services believes that, if implemented as proposed, the new Basel II framework will discourage originating banks from holding exposures rated less than investment grade. Banks would be deterred by the high regulatory capital charges on securitization-related exposures that are unrated or rated below 'BBB-' at the time of funding.

Under Basel II, a bank that either sponsors ABCP conduits or provides liquidity and/or credit support is considered to be an "originating bank." Regulatory capital charges proposed under Basel II could have a significant impact, not only on the types of assets financed through the ABCP conduits, but also on the liabilities that conduits issue to finance their purchases. The following trends are likely, based on a review of the final rules presented by the Bank for International Settlements:

- An increase in the issuance of extendible notes.
- An increase in the volume of commercial paper (CP) issued by Structured Investment Vehicles (SIVs) or SIV type structures.
- An increase in the volume of CP issued by CDOs.
- A decline in the volume of CP issued by securities arbitrage vehicles.

The regulatory capital costs associated with liquidity facilities will accelerate the growth of the extendible note structures that limit the use of third-party liquidity, such as those that use cash flows generated by the assets to pay off the extendible notes or a pure market value approach to calculating advance rates. CP issued by SIVs based on pure market value advance rates and cash flow analyses are likely to increase as well. In addition, Standard & Poor's expects to see more alternative structures, such as total return swaps, used in place of liquidity facilities.

The high-risk weights associated with non-investment-grade assets will provide a further boost to the issuance of CDOs of ABS as banks reduce reliance on these non-investment-grade assets to minimize the regulatory capital costs associated with holding such assets on their balance sheets. Increasingly, these CDOs have been issuing a senior ABCP tranche that replaces at least part of the 'AAA' CDO notes. The lower cost of funding through CP issuance relative to the spreads demanded by 'AAA' noteholders flows through to the equity participants in these structures. In turn, the increase in returns to equity participants facilitates the ease of execution of CDOs of ABS.

According to some estimates, as much as 50% of the super senior tranches issued by these CDOs has been bought by ABCP conduits. However, the requirement of funding for investment-grade assets by liquidity facilities to qualify as eligible liquidity facilities will endanger the existence of securities arbitrage conduits, since the increased credit enhancement requirements may wipe out the economics of these programs. Nevertheless, a lack of demand by securities arbitrage conduits could possibly be offset by increased demand from banks for on-balance-sheet financing due to reduced risk weights for higher rated assets.

Calculating Regulatory Capital Under Basel II

The Basel II framework requires banks that provide liquidity facilities and/or credit enhancement in the form of program wide credit enhancement (PWCE) to ABCP conduits to hold regulatory capital against these exposures. The regulatory capital charge is calculated as follows:

$$\text{Regulatory Capital} = \text{CCF} \times \text{RW} \times 8\% \times \text{bank's exposure}$$

Where:

- CCF is the Credit Conversion Factor for off-balance-sheet exposures; and
- RW is the Risk Weight based on the rating of the exposure.

Since most securitization exposures are off-balance-sheet exposures, a credit conversion factor (CCF) is used to determine the risk-weighted assets of a securitization exposure. The maximum CCF equals 100%, implying that the exposure is treated as if it were on balance sheet. Basel II, by requiring 100% CCFs for most securitization related exposures, does not give any off-balance sheet benefit to financial institutions. The exception to 100% CCFs, in the ABCP context, is eligible liquidity facilities (ELF) discussed later in this article.

The maximum regulatory capital specified in Basel II, as shown in tables 1 and 2 below, is a deduction, i.e., the regulatory capital is equal to the notional exposure. What is the associated risk weight if the capital required is equal to the notional exposure? Consider the example below.

Assuming a CCF of 100%, and a \$100 exposure, using the formula for calculating regulatory capital, a deduction results in the following risk weight:

$$\text{Regulatory Capital} = \$100 = 100\% (\text{CCF}) \times \text{RW} \times 8\% \times \$100 (\text{Banks' exposure})$$

- $1 = \text{RW} \times 8\%$
- $\text{RW} = 100/8 = 1250\%$

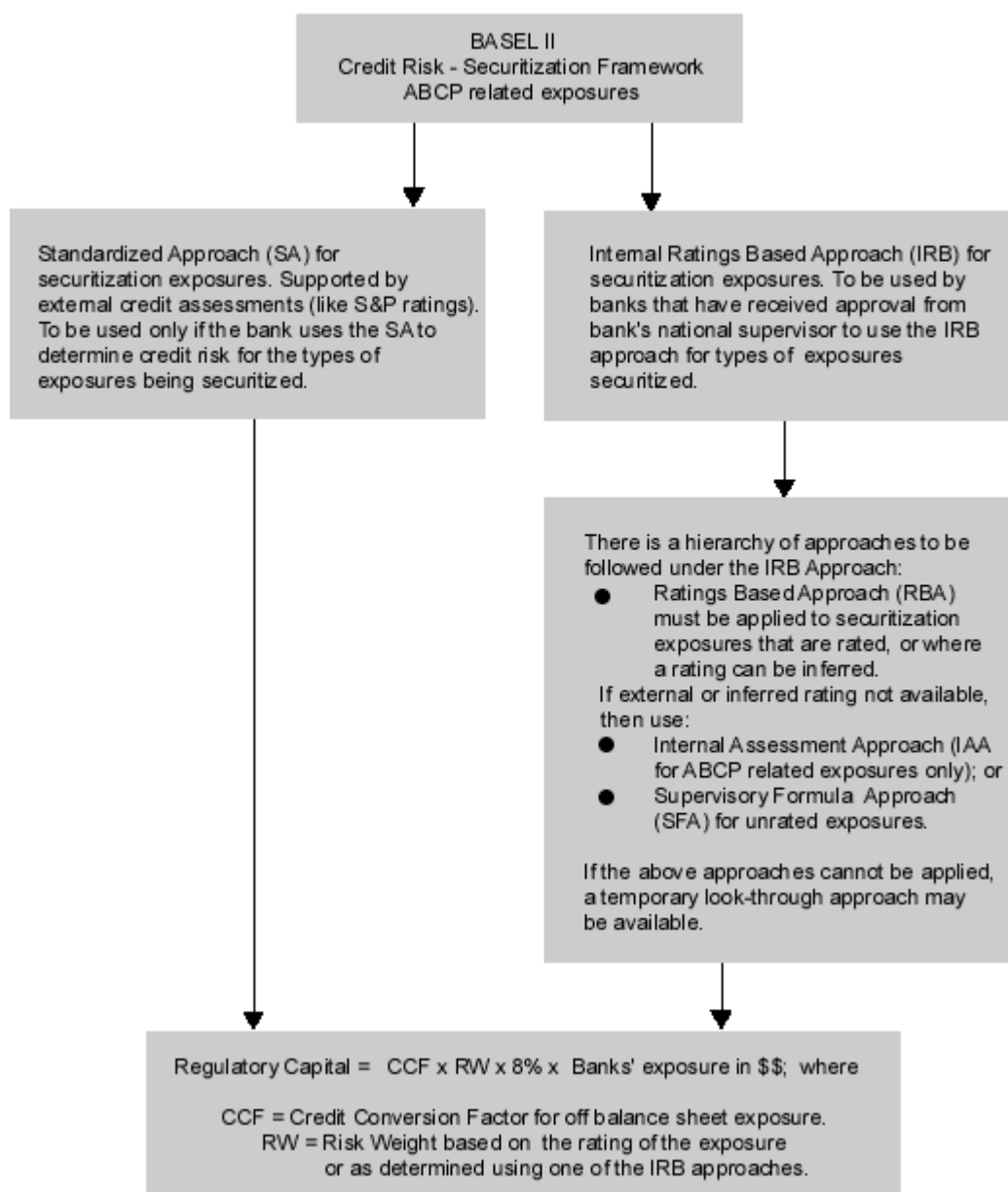
In contrast to the risk weight for a securitization exposure rated 'BB-' or below of 1,250%, the risk weight for an unrated corporate or sovereign exposure is 100%.

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Regulatory Capital Requirements for Liquidity Exposures

The RWs and CCFs for determining regulatory capital requirements for bank exposures in the form of liquidity facilities depend on whether the bank is using the standardized or IRB approach. The final rules for ABCP exposures under Basel II can be simplified with the help of the following charts and tables.

Chart 1



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Risk Weights and Credit Conversion Factors

Risk weights are determined by the ratings unless the ratings can be inferred based on their position in the waterfall of payments relative to rated tranches. Most conduit sponsors have indicated that they will use the IRB approach and expect to qualify for the internal assessment approach (IAA) for their ABCP-related exposures. According to Basel II, a bank may use its internal assessments of the credit quality of the securitization exposures that it extends to ABCP programs subject to supervisory approval. A lengthy list of operational guidelines has to be satisfied to be eligible for the IAA, including following published rating methodologies for the different asset classes securitized.

The flexibility seemingly afforded by the IAA makes it desirable to banks, although satisfaction and approval of the operational guidelines seems rather daunting. The

maximum capital requirement for an originator under any of the IRB approaches (RBA, IAA, or SFA) is equal to the IRB capital requirement (Kirb) that would have been assessed against the underlying exposure had it not been securitized.

There is likely to be a limited group of banks that will follow the Standardized Approach (SA). If one were to focus on risk weights only, as presented in the following tables, the regulatory capital requirements are always considerably less for the IRB banks as compared to the capital required of SA banks. However, the one exception is unrated short-term ELF's as further discussed below.

Table 1 Comparative Risk Weights: Short-Term Ratings		
External rating	Standardized approach (explicit external ratings) (%)	RBA: risk weights for senior positions and eligible senior IAA exposures (%)
A-1	20.00	7.00
A-2	50.00	12.00
A-3	100.00	60.00
All other ratings/unrated	Deduction	Deduction

Table 2 Comparative Risk Weights: Long-Term Ratings		
Rating	Standardized approach (explicit external ratings) (%)	IRB approach: risk weights for senior positions and eligible senior IAA exposures
AAA	20.00	7.00
AA	20.00	8.00
A+	50.00	10.00
A	50.00	12.00
A-	50.00	20.00
BBB+	100.00	35.00
BBB	100.00	60.00
BBB-	100.00	100.00
BB+	Deduction*	250.00
BB	Deduction*	425.00
BB-	Deduction*	650.00
Below BB- and unrated	Deduction¶	Deduction§

*Originators are required to deduct all retained securitization exposure rated below investment grade. Investors would apply a 350% RW against 'BB' exposures. ¶Unless the unrated exposure is in a second loss position; is a most senior securitization exposure or relates to an eligible liquidity facility. §Unless the SFA, IAA, or temporary look through approach can be applied.

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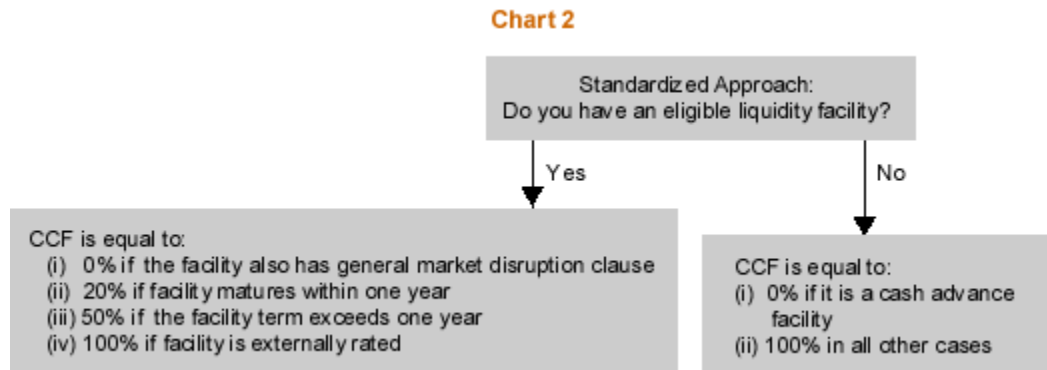
Determining Credit Conversion Factors

The CCFs for most securitization exposures is 100% unless an ELF is in place under some approaches. Key criteria for ELF's under Basel II include:

- Facility documentation identifies and limits circumstances under which liquidity can be drawn. Draws are limited to the amount likely to be repaid fully from liquidation of underlying assets plus seller provided credit enhancement.
- Facility is subject to asset quality tests that preclude funding for defaulted assets. In addition, if the exposures that a liquidity facility is required to fund are externally rated securities, the facility can only be used to fund securities that are externally rated investment grade at the time of funding.
- No draws are permitted if all credit enhancements from which liquidity can benefit has been exhausted.

- Repayment of draw is not subordinated to CP or subject to deferral or waiver.

Under the SA, the CCFs for liquidity exposures are determined as follows:



Under the standardized approach, if an exposure is rated, a CCF of 100% must always be applied. The rationale behind a 100% CCF for ELF's that are explicitly rated versus a 20% CCF for ELF's that are unrated is unclear under Basel II.

Under the IRB approach, the CCFs are 100% under the IAA and RBA as well as when a facility is externally rated regardless of the maturity of the facility. Under the IRB approach, where it is not practical for the bank to use the SF or IAA, a temporary look-through-type approach has been provided for ELF's. The CCF for such ELF's is 50% if the original maturity is less than one year and 100% if the original maturity exceeds one year. If an ELF benefits from a general market disruption clause, the CCF is 20% regardless of the original maturity of the facility.

The rationale behind the differential treatment between the SA and IRB approach of ELF's, especially those that can be drawn only in the event of a general market disruption, is unclear as well.

Most liquidity facilities in the ABCP market today have an original maturity of less than one year. What is the likely impact of these risk weights and CCFs on regulatory capital requirements for banks? Here are some examples:

Examples:

The minimum regulatory capital charge for an unrated eligible liquidity facility is:

$$20\% \text{ (RW for AAA)} * 20\% \text{ (CCF)} * 8\% = 32 \text{ basis points for standardized bank}$$

$$7\% \text{ (RW for AAA)} * 100\% \text{ (CCF)} * 8\% = 56 \text{ basis points for an IRB bank}$$

For non-securitization exposures, the regulatory capital for IRB banks is considerably lower than those for SA banks.

However, if the conduits in general have 'A+' exposures and the receivables pool is explicitly rated by Standard & Poor's for purposes of standardized banks or 'A+' as derived based on internal ratings for IRB banks, the regulatory capital requirements for an unrated eligible liquidity facility will be:

$$50\% \text{ (RW for A+)} * 20\% \text{ (CCF)} * 8\% = 80 \text{ basis points for standardized bank}$$

$$10\% \text{ (RW for A+)} * 100\% \text{ (CCF)} * 8\% = 80 \text{ basis points for IRB banks}$$

Based on the above example, the regulatory capital treatment is neutral for a standardized versus IRB bank for the banks that have ABCP rated 'A-1' and are underwriting to an 'A+' standard.

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Regulatory Capital Requirements for PWCE Exposures

Bank exposure in the form of PWCE is unrated. According to Basel II, most unrated securitization-related exposures have high-risk weights (1,250% as compared to 100% for corporate exposure) since the regulatory capital required is equal to the exposure amount. If a bank has \$500 million in a program-level LOC, the bank would have to hold \$500 million in regulatory capital. However, the calculation of risk weights and the resulting regulatory capital is slightly different for exposures in a second loss position, such as PWCE.

For exposures in a second loss position, the RW is the greater of (i) 100% or (ii) the highest RW assigned to the underlying individual exposures covered by the facility. Under Basel II, an exposure is considered to be in a second loss position if there is (i) a significant first loss layer (ii) associated credit risk is investment grade or better and (iii) bank holding the unrated exposure does not provide the first loss. For PWCE exposures, the CCF is 100%. So if the PWCE equals \$500 million, the least amount of regulatory capital will equal \$500 million x 8% = \$40 million.

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Overlapping Exposures

Conduit sponsors often provide PWCE in the form of an LOC, for instance, (generally 8% to 10%) as well as liquidity (generally 102%) to an ABCP conduit. According to Basel II, in the case of overlapping facilities provided by the same bank, the bank does not need to hold additional capital for the overlap. Rather, it is only required to hold capital once for the position covered by the overlapping facilities. Where the overlapping facilities are subject to a different conversion factor, the bank must attribute the overlapping part to the facility with the highest conversion factor.

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Basel II Could Affect Banks' Conduit Business

From the perspective of the financial institution originator, it will be harder to recognize the same regulatory benefits from a securitization that the originator might have enjoyed under Basel I. Added to the increased capital requirements of the originator are the increased regulatory requirements of both ABCP liquidity providers and investors that are also subject to Basel II. The costs faced by each of these participants in a securitization transaction, not only in terms of increased regulatory capital but also implementation and ongoing compliance, will undoubtedly raise the cost of conduit activity. Faced with increased cost considerations, originators and sellers of assets will need to weigh the benefits of the conduit in terms of access to a diversified investor base and issuer anonymity, against the costs and benefits of term financing to the extent that the originators and sellers have the flexibility to pursue that option.

The final application of the Basel II rules is still in flux and the costs of complying with regulatory pronouncements continue to mount. In a global economy, jurisdictional differences in application of the Basel rules will clearly affect the competitiveness of the banks in these jurisdictions.

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