

recognized for regulatory capital purposes, the external credit rating on a securitization exposure would have to be public and reflect the entire amount of credit risk exposure the banking organization has with regard to all payments owed to it under the exposure. In particular, if a banking organization is owed both principal and interest on a securitization exposure, the external rating on the exposure would have to fully reflect the credit risk associated with both payment streams. The Agencies propose to establish criteria to ensure the integrity of external ratings processes and banking organizations' use of these ratings under the RBA. These criteria are expected to be consistent with the proposed guidance provided in the New Accord (paragraph 525).

In certain circumstances, an "inferred rating" may be used for risk weighting a non-rated securitization exposure. Similar to the general risk-based capital rules, to qualify for use of an inferred rating, a non-rated securitization exposure would have to be senior in all respects to a subordinate rated position within the same securitization transaction. Further, the junior rated tranche would have to have an equivalent or longer remaining maturity than the non-rated exposure. Where these conditions are met, the non-rated exposure would be treated as if it had the same rating (an "inferred rating") as that of the junior rated tranche. External and inferred ratings would be treated equivalently.

Under the RBA, the capital charge per dollar of a securitization exposure would depend on: (i) The external rating (or inferred rating) of the exposure, (ii) whether the rating reflects a long-term

or short-term assessment of the exposure's credit risk, and (iii) a measure of the effective number—or granularity—of the underlying exposures (N).<sup>34</sup> For a securitization exposure rated AA or AAA, the RBA capital charge also would depend on a measure of the exposure's relative seniority in the overall transaction (Q).<sup>35</sup>

Tables 1 and 2 below present the risk weights that would result from the RBA when a securitization exposure's external rating (or inferred rating) represents a long-term or short-term credit rating, respectively. In both tables, the risk weights in column 2 would apply to AA and AAA-rated securitization exposures when the effective number of exposures (N) is 100 or more, and the exposure's relative seniority (Q) is greater than or equal to  $0.1 + 25/N$ . If the underlying exposures are retail exposures, N would be treated as infinite and the minimum qualifying value of Q would be 0.10. The Agencies anticipate that these risk weights would apply to AA and AAA-rated tranches of most retail securitizations. Column 4 would apply only to securitizations involving non-retail exposures for which N is less than 6, and column 3 would apply in all other situations.

Within each table, risk weights increase as external rating grades decline. Under the Base Case (column 3), for example, the risk weights range from 12 percent for AAA-rated exposures to 650 percent for exposures rated BB-. This pattern of risk weights is broadly consistent with analyses employing standard credit risk models and a range of assumptions regarding correlation effects and the types of exposures being securitized.<sup>36</sup> These analyses imply that, compared with a

corporate bond having a given level of stand-alone credit risk (for example, as measured by its expected loss rate), a securitization tranche having the same level of stand-alone risk—but backed by a reasonably granular and diversified pool—will tend to exhibit more systematic risk.<sup>37</sup> This effect is most pronounced for below-investment grade tranches, and is the primary reason why the RBA risk weights increase rapidly as ratings deteriorate over this range—much more rapidly than for similarly rated corporate bonds. Similarly, for highly granular pools, the risk weights expected to apply to most AA and AAA-rated securitization exposures (7 percent and 10 percent, respectively) decline steeply relative to the risk weight applicable to A-rated exposures (20 percent, column 3)—again, more so than might be the case for similarly rated corporate bonds. The decline in risk weights as ratings improve over the investment grade range is less pronounced for the Base Case and for tranches backed by non-granular pools (column 4).

For securitization exposures rated below BB-, the proposed A-IRB treatment—deduction from capital—would be somewhat more conservative than suggested by credit risk modeling analyses. However, the Agencies believe this more conservative treatment would be appropriate in light of modeling uncertainties and the tendency for securitization exposures in this range, at least at the inception of the securitization transaction, to be non-traded positions retained by an originator because they cannot be sold at a reasonable price.

TABLE 1.—ABS RISK WEIGHTS BASED ON LONG-TERM EXTERNAL CREDIT ASSESSMENTS

External rating (illustrative)	Thick tranches backed by highly granular pools	Base case	Tranches backed by non-granular pools
AAA .....	7% .....	12% .....	20%
AA .....	10% .....	15% .....	25%
A .....	N/A .....	20% .....	35%
BBB+ .....	N/A .....	50% .....	50%
BBB .....	N/A .....	75% .....	75%
BBB- .....	N/A .....	100% .....	100%
BB+ .....	N/A .....	250% .....	250%
BB .....	N/A .....	425% .....	425%
BB- .....	N/A .....	650% .....	650%
Below BB- .....	N/A .....	Deduction .....	Deduction

<sup>34</sup> N is defined more formally in the discussion below of the Supervisory Formula Approach.

<sup>35</sup> Q is defined as the total size of all securitization exposures rated at least AA- that are pari passu or junior to the exposure of interest, measured relative to the size of the pool and

expressed as a decimal. Thus, for a securitization transaction having an AAA-rated tranche in the amount of 70 percent of the pool, an AAA-rated tranche of 10 percent, a BBB-rated tranche of 10 percent, and a non-rated tranche of 10 percent, the values of Q associated with these positions would be 0.80, 0.10, 0, and 0, respectively.

<sup>36</sup> See Vladislav Peretyatkin and William Perraudin, "Capital for Asset-Backed Securities," Bank of England, February 2003.

<sup>37</sup> See, for example, Michael Pykhtin and Ashish Dev, "Credit Risk in Asset Securitizations: Analytical Model," *Risk* (May 2002) S16-S20.