

This is not the first time that the agencies have addressed the question of whether to impose a capital charge on securitizations of revolving credit exposures incorporating early amortization provisions. On March 8, 2000, the agencies published a notice of proposed rulemaking on recourse and direct credit substitutes (65 FR 12320). In that proposal, the agencies proposed a fixed conversion factor of 20 percent to be applied to the amount of assets under management in all revolving securitizations that contained early amortization features, in recognition of the risks associated with these structures. The agencies acknowledge that the March 2000 proposal was not particularly risk sensitive and would have required the same amount of capital for all securitizations of revolving credit exposures that contained early amortization features, regardless of the risk present in the securitization transaction. In a subsequent November 2001 rulemaking (66 FR 59614), which implemented many of the proposals in the March 2000 proposal, the agencies reiterated their concerns with early amortization, indicating that the risks associated with securitization, including those posed by an early amortization feature, are not fully captured in the current capital rules.

In the interim, the Basel Committee on Banking Supervision (BCS) has set forth a more risk-sensitive proposal that would assess capital against securitizations of revolving exposures with early amortization features based on key indicators of risk, such as excess spread levels. Virtually all securitizations of revolving retail credit facilities that include early amortization provisions rely on excess spread as an early amortization trigger. For example, early amortization generally commences once excess spread falls below zero for a given period of time. International supervisors recognize that there is a connection between early amortization and excess spread levels. In a separate rulemaking, the agencies currently are seeking comment on the proposals the BCS has set forth for large, internationally active banking organizations.<sup>4</sup> The risk-based capital charge, on which comment is sought in this proposed rulemaking for the

exposures arising from early amortization structures, is based on the proposal set forth by the Basel Supervisors Committee.<sup>5</sup>

The agencies believe that the risks associated with early amortization exist for all banking organizations that utilize securitizations of revolving exposures to fund their operations. Further, the agencies acknowledge that while early amortization events are infrequent, an increasing number of securitizations have been forced to unwind and repay investors earlier than planned. Given these concerns, the agencies are requesting comment on whether to impose a more risk-sensitive approach for assessing capital against securitizations of revolving retail credit exposures that incorporate early amortization provisions, which would apply to all banking organizations that use these vehicles to fund their operations.

Such an early amortization capital charge would be applied to securitizations of revolving retail credit facilities that include early amortization provisions, which are expected predominantly to be credit card securitizations. Since risk-based capital already is held against the on-balance sheet seller's interest, such a capital charge would be assessed against only the off-balance sheet investors' interest and only in the event that the excess spread in the transaction has declined to a predetermined level. The proposed capital requirement would assess increasing amounts of risk-based capital as the level of excess spread approaches the early amortization trigger (typically, a three-month average excess spread of zero). Therefore, as the probability of an early amortization event increases, the capital charge against the off-balance sheet portion of the securitization also would increase.

At this time, the agencies are only requesting comment on whether to assess risk-based capital against securitizations of revolving retail credit exposures (defined to include personal and business credit card accounts), even though there are some transactions that securitize revolving corporate exposures, such as certain collateralized loan obligations. The agencies are considering the appropriateness of applying an early amortization capital charge to securitizations of non-retail revolving credit exposures and request comment on this issue.

<sup>5</sup> The credit conversion factors used in this proposed rulemaking mirror in the agencies' July 2003 Advanced Notice of Proposed Rulemaking for non-controlled early amortization of uncommitted retail credit lines.

The maximum risk-based capital requirement that would be assessed under the proposal would be equal to the greater of (i) the capital requirement for residual interests or (ii) the capital requirement that would have applied if the securitized assets were held on the securitizing banking organization's balance sheet. The latter capital charge generally is 8 percent for credit card receivables. For example, if a banking organization, after securitizing a credit card portfolio, retains a combination of an interest-only strips receivable, a spread account, and a subordinated tranche that equaled 12 percent of the transaction, then under the agencies' risk-based capital standards the organization would be assessed a dollar-for-dollar capital charge against the 12 percent of retained, subordinated securitization exposures, net of any associated deferred tax liabilities. In this example, there would be no incremental charge for early amortization risk. Alternatively, if the amount of the retained exposures were less than 8 percent, which is the risk-based capital charge for credit card receivables held on the balance sheet, then the charge against the retained securitization exposures plus any early amortization capital charge would be limited to 8 percent. Potentially, if the exposure were limited by contract, the risk-based capital requirement could be limited to that contractual amount under the low-level exposure rule.

In order to determine whether a banking organization securitizing revolving retail credit facilities containing early amortization provisions must hold risk-based capital against the off-balance sheet portion of its securitization (that is, the investors' interest), the three-month average excess spread must be compared against the difference between (i) the point at which the securitization trust would be required by the securitization documents to trap excess spread (spread trapping point) in a spread or reserve account and (ii) the excess spread level at which early amortization would be triggered. This differential would be referred to as the excess spread differential (ESD). If the securitization documents do not require excess spread to be trapped, then for purposes of this calculation the spread trapping point is deemed to be 450 basis points higher than the early amortization trigger. If such a securitization does not employ the concept of excess spread as a transaction's determining factor of when an early amortization is triggered, then a 10 percent credit conversion factor is applied to the outstanding principal

<sup>4</sup> On August 4, 2003, the agencies published an advanced notice of proposed rulemaking (ANPR) in the *Federal Register* seeking public comment on the implementation of the new Basel Capital Accord in the United States. The ANPR presents an overview of the proposed implementation in the United States of the advance, approaches to determining risk-based capital requirements for credit and operational risk.