Basel I-A: A Capital Framework for the Rest of the Industry

By: Raymond Natter
Barnett Sivon & Natter
Washington, DC

Introduction

On October 20, 2005, the Federal Banking Agencies published an advanced notice of proposed rulemaking, or "ANPR," soliciting comments on proposed changes in the capital rules for banks, savings associations, and bank holding companies that will not be subject to the Basel II framework.[1] The comment period closed on January 18, 2006.

The ANPR was issued in response to industry and Congressional concerns that establishing a separate Basel II capital structure for large institutions and leaving the rest of the industry subject to the Basel I standards could result in competitive disadvantages for the non-Basel II banking organizations. The ANPR is intended to be the first step in the agencies' attempt to address these concerns, while at the same time making progress in their long-term goal of making capital standards more risk sensitive. The modified capital standard is informally referred to as "Basel I-A."

The agencies announced that they will be guided by the following principles in developing the Basel I-A proposal: (i) promotion of safe and sound banking and a prudent level of regulatory capital; (ii) the need to balance risk sensitivity and operational feasibility; (iii) the avoidance of undue regulatory burden; (iv) establishment of incentives for banking organizations; and (v) the mitigation of material distortions in capital requirements between large and smaller institutions.

General Comments

The ANPR solicited comment on both specific proposals and more generally on how to improve the capital requirements. After considering these comments, the agencies intend to publish a revised notice of proposed rulemaking implementing the Basel I-A standards, as well as a notice of proposed rulemaking to implement the Basel II standard, in the same time frame.

Specific Proposals

1. Increase the Number of Risk Weight Baskets

Under the current risk-based capital standard assets are assigned one of five risk weights. Thus, for example, U.S. Treasury securities are given a risk-weight of 0 percent; claims on depository institutions incorporated in a country that is a member of the Organization for Economic Cooperation and Development (OECD) are given a risk-weight of 20 percent; prudently underwritten mortgage loans are given a risk-weight of 50 percent; commercial loans are risk-weighted at 100 percent; and certain below investment grade asset-backed securities are given a 200 percent risk weight.

[1] 70 Fed. Reg. 61068 (2005).

The ANPR sought comments on increasing the number of risk-weight baskets, and suggests adding four new baskets: 35, 75, 150, and 350 percent. The ANPR asked whether this will permit better alignment of required capital and risk, whether the suggested additional baskets are appropriate, and whether more or fewer baskets should be added, and whether a lower weighted basket should be included for high quality assets with very low historical default rates.

2. Use of External Credit Ratings

Under the existing regulatory framework, banking organizations may rely on external ratings from a nationally recognized statistical rating organization (NRSRO) for certain assets, e.g. recourse obligations, direct credit substitutes, residual interests in securitizations, and asset- and mortgage-backed securities. Depending on the rating, these assets may be assigned a risk-weight as low as 20 percent or as high as 200 percent. The ANPR proposes using NRSRO ratings to establish the risk weight for a broad range of exposures.[2]

The ANPR asked for comments on whether the proposal is appropriately risk sensitive, the amount of burden that this approach may generate for the industry, the use of other methodologies to establish risk weights for rated exposures, and methods to assign risk weights to unrated positions.

3. Financial Collateral and Guarantors

Under existing regulations, a banking organization will get preferential capital treatment if an asset is collateralized by cash on deposit, U.S. or OECD Government securities, U.S. agency obligations, Government Sponsored Entity obligations, and securities issued by multilateral lending institutions or regional development banks. Guarantees are also recognized, but again only if issued by certain recognized types of entities. Entities seeking better capital treatment based on collateral must have management systems that can track collateral and readily determine its realizable value.

According to the ANPR, the agencies are considering expanding the types of collateral that will be recognized for capital purposes to include externally rated debt and asset-backed securities (including mortgage-backed securities), as well as non-OECD Government obligations that have an investment grade rating. The agencies are also considering increasing the list of recognized guarantors for capital purposes to include any entity whose long-term senior debt has an investment grade rating.

4. One-to-Four Family Mortgages

First lien residential mortgage loans that are prudently underwritten are currently placed in the 50 percent risk-weight basket. The agencies note that this treatment does not accurately reflect the risks of these assets, and are therefore proposing several options to correct this problem. The ANPR is also proposing modifications relating to non-traditional loans and certain second mortgage loans and home equity lines of credit.

- LTV Option

[2] Proposed risk-weights would range from 20 percent (highest two long-term investment grades) to 350 percent (two or more categories below investment grade).

One option is to assign a risk weighting to first lien mortgage loans based on the loan-to-value (LTV) ratio. Loans with an LTV of 60 percent or less would be assigned a risk-weight of 20 percent, loans with an LTV of between 61 and 80 percent would be assigned a risk-weight of 35 percent, and loans with an LTV of 90 percent or less would have a risk-weight of 50 percent. Mortgage loans with an LTV above 90 percent would be assigned a risk-weight of 100 percent.

With respect to this proposal, the agencies note that the LTV would be determined after taking into account private mortgage insurance (PMI) provided by an insurer with a long-term credit rating of "A" or higher (third highest investment grade rating). However, PMI covering a pool or portfolio of loans is not currently considered when determining the LTV of an individual loan. The agencies also note that some PMI contracts require the lender to absorb some measure of loss before the insurance is payable, and such insurance would not be recognized at all under the proposal. The agencies are also concerned that a blanket acceptance of PMI might overstate its effectiveness in mitigating risk. Thus, the agencies suggest that a floor might be placed on the risk-weight for certain PMI protected mortgages.

The ANPR asked for specific comment: (i) on the use of LTV to determine risk weights; (ii) whether the LTV ratio should be updated periodically; (iii) whether portfolio level PMI should be considered when determining risk-weight assignments; (iv) alternative approaches that are sensitive to counterparty credit risk associated with PMI; and (v) whether the regulation should impose floors for certain mortgages subject to PMI, especially higher-risk loans and novel products.

- Credit Risk and LTV Option

An alternative approach raised in the ANPR is to consider credit risk and LTV ratios in assigning risk weights. Credit risk would be determined by credit scores, debt-to-income ratios, or another relevant measure of credit quality. The measure of credit risk would then be related to the LTV of the loan to determine the proper risk-weight basket for that asset.

ANPR sought comments on: (i) the use of an assessment mechanism based on LTV ratios in combination with a measure of credit risk; (ii) the impact of the use of credit scores on the availability of credit or prices for lower income borrowers; and (iii) whether LTV ratios and measures of creditworthiness should be updated annually or quarterly, and how these parameters might be updated to reflect the changing risks of the loan as it matures and as property values and the borrower's credit assessment fluctuate.

- Non-traditional Mortgage Products

The ANPR specifically addresses non-traditional mortgage products, such as interest-only mortgages, loans with an LTV in excess of 100 percent, and loans with a negative amortization feature. The agencies solicited comments on whether these loans should be included in the same matrix as traditional mortgages or whether these loans pose unique risks that warrant a higher capital requirement.

- Second Liens and Credit Lines

Currently, if a lender holds both a first and second mortgage (including a home equity line of credit ("HELOC"), both loans are aggregated when determining the LTV ratio and risk-weight. The agencies are not proposing to change this treatment.

If a lender holds only a second lien or HELOC, but not the first lien, the agencies look at the combined LTV for both loans at the time of origination of the second lien or HELOC. If the combined LTV exceeds 90 percent, the agencies are proposing to assign a risk-weight to the second lien or HELOC in excess of 100 percent.

- Multifamily Residential Mortgages

Generally, multifamily residential mortgage loans are currently risk-weighted at 100 percent. The ANPR sought comments and data on whether such loans or a specific subset of such loans (e.g. based on size, maturity, LTV, or other factors) should receive a more favorable risk-weight assignment.

5. Other Retail Exposures

The ANPR seeks comments on whether other retail exposures, such as consumer loans, credit cards, and automobile loans could be assigned risk weights based on the actual riskiness of the loan. One approach might be to base the risk-weight on the borrower's credit score or ability to service the debt, and collateral LTV ratios. The ANPR solicited comment on this and other methods that would increase risk sensitivity without undue burden. Comments were also requested on what risk-baskets would be appropriate for different risk measures, and the impact of any changes on credit availability for lower income borrowers.

6. Short-Term Commitments

Banks that hold short-term commitments of less than one year in duration, such as an unfunded line of credit that expires within 12 months, are not required to hold capital to support these obligations.[3] Long-term commitments of one year or greater are converted to on-balance sheet credit equivalent using a 50 percent conversion factor.

The agencies note that since short-term commitments expose banking organizations to credit risk, it may be more appropriate to subject these obligations to a capital charge. The ANPR suggests that a 10 percent conversion factor be applied to short-term commitments. Exceptions would be made for commitments that are cancelable at any time by the banking organization without prior notice, and for commitments that effectively provide for automatic cancellation due to deterioration in a borrower's credit. Comments were solicited on this approach as well as on an alternative approach that would apply a 20 percent conversion factor to all commitments, both short- and long-term.

7. Loans 90 Days Past Due or in Nonaccrual

The ANPR proposes to increase the risk-weight assigned to loans that are 90 days or more past due and those in nonaccrual status. The amount of the exposure assigned to the higher risk-weight basket would be reduced by any reserves directly allocated to cover losses on the loan. The ANPR solicits comments on all aspects of this proposal.

8. Commercial Real Estate

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[3] One exception is for short-term unfunded liquidity facilities supporting asset-backed commercial paper programs. These facilities are converted to on-balance sheet credit equivalent using a 10 percent conversion factor.

The current risk weight for commercial real estate loans, including acquisition, development and construction loans, is generally 100 percent. The ANPR is proposing that these loans be given a higher risk-weighting, unless the loan satisfies all of the requirements set out in the agencies prudential standards for such loans and the project is supported by a substantial amount of borrower equity, such as 15 percent of the completion value. If a loan meets these two requirements, it would continue to be assigned a risk-weight of 100 percent. The agencies are interested in other factors that could be used to determine the riskiness of the loan, such as LTV ratios and credit assessments.

9. Small Business Loans

The ANPR is proposing to reduce the risk-weight for small business loans. To qualify, the total exposure to that business entity would have to be less than $1 million. Under one alternative, to be eligible for the lower capital requirement, the loan would have to fully amortize over a period of 7 years or less, fully perform, and be collateralized. The loan underwritten would have to include an assessment of the collateral and the borrower's financial condition and ability to repay the debt. Under these circumstances, the agencies suggest that a risk-weight of 75 percent might be acceptable. Another alternative is to assign a risk-weight based on a credit assessment of the principals, if the principals personally guarantee the loan. The agencies sought comment on any alternative approaches for improving risk sensitivity for small business loans.

10. Early Amortization

The ANPR notes that securitizations of revolving retail credit facilities, such as credit cards, typically contain provisions for the early amortization of the securitization if certain triggering events occur, such as a decline in the excess spread account. The agencies believe that an early amortization event creates risks for the originating lending institution. First, during the early amortization distribution, the interests of the originating bank or savings association will typically be subordinated to those of the security holders, thus absorbing more than its pro rata share of any loss. Second, the lending institution will need to obtain a new source of liquidity, and therefore may fact significant liquidity risks. Third, the desire to avoid an early amortization provides incentives for the originating lender to provide additional financial support to the securitization.

To address these concerns, the ANPR suggests imposing a capital charge on the securitized personal and business credit card assets, as well as possibly other securitizations of revolving credit exposures. One option is to impose a 10 percent conversion factor against such receivables in a securitization with an early amortization feature. Another approach is to impose a capital charge against the bank's interest in the securitization (the seller's interest) based on a trigger, such as the level of the excess spread account. As the level of the spread account declines toward the trigger point, the capital charge against the seller's interest would increase from 0 percent to 100 percent.

The agencies solicited comments on whether to adopt either approach, and whether either treatment fully addresses the potential risks of these securitizations. Comments were also solicited on whether other early amortization triggers are used, such as the level of delinquencies, and if there are other factors or approaches the agencies should consider.

11. Application of the Proposed Revisions

The agencies are considering whether to permit some banking organizations to elect to continue to use the current Basel I framework, or portions of it, in lieu of the Basel I-A approach.

The ANPR requested comments on whether there is an asset size below which banking organizations should be given this option. Comments were also solicited on the concept of allowing banking organizations to choose between Basel I and Basel I-A standards for certain classes of assets.

12. Basel II Floor

When the Basel II framework is implemented, the agencies expect to establish a floor for the first three years. The floor would provide that banking organizations must maintain a certain percentage of capital as calculated under Basel I, even if the Basel II framework would result in a lower amount of capital. The agencies asked for comments on whether the Basel II floor should be based on the current Basel I, or the modified Basel I-A to be developed under the ANPR.

Conclusion

The Basel I-A ANPR represents a good first step by the agencies in making the current capital framework more risk sensitive and for alleviating potential competitive concerns with a two-tiered capital system. However, as in any first attempt in adjusting a complex regulatory structure, improvements can be made to make the proposal even more risk sensitive and to provide additional comfort to the non-Basel II institutions concerned about the competitive impacts of the Basel II framework. One fundamental issue that must be addressed is whether this proposal goes far enough to achieve these goals. This is a factor that the agencies must consider if they wish to obtain widespread industry support for Basel II.