Capital Requirements for Downgraded Securities - Direct Credit Substitutes

Community Bankers Forum, Abingdon, VA

Donna A. Thompson, CFA, FRM

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Direct Credit Substitute – Definition

Appendix A Section 4 (a)(4)(iii)

- An arrangement in which a bank assumes, in form or in substance credit risk associated with an on- or off-balance sheet asset or exposure that was not previously owned by the bank and the risk assumed by the bank exceeds the *pro rata* share of the bank's interest in the third-party asset.
- Under the risk-based capital rules, the definition of a direct credit substitute explicitly includes items such as purchased subordinated asset- and mortgage-backed securities (and CDOs)
- Senior positions in ABS and MBS structures do not meet the definition of a direct credit substitute (because it does not absorb losses before another designated senior tranche)

Non-Agency Mortgage Backed Securities

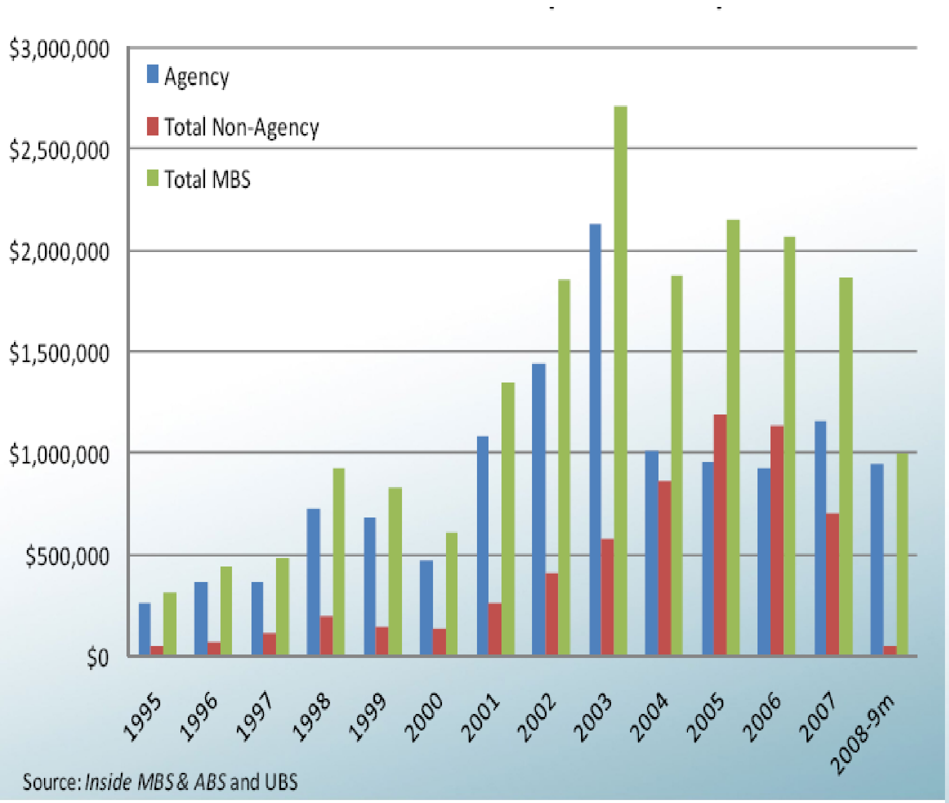
Pre 3Q 2007

- Yields exceeded comparable government agency products
- Volume of securitized product indicated significant liquidity
- Favorable risk-based capital treatment

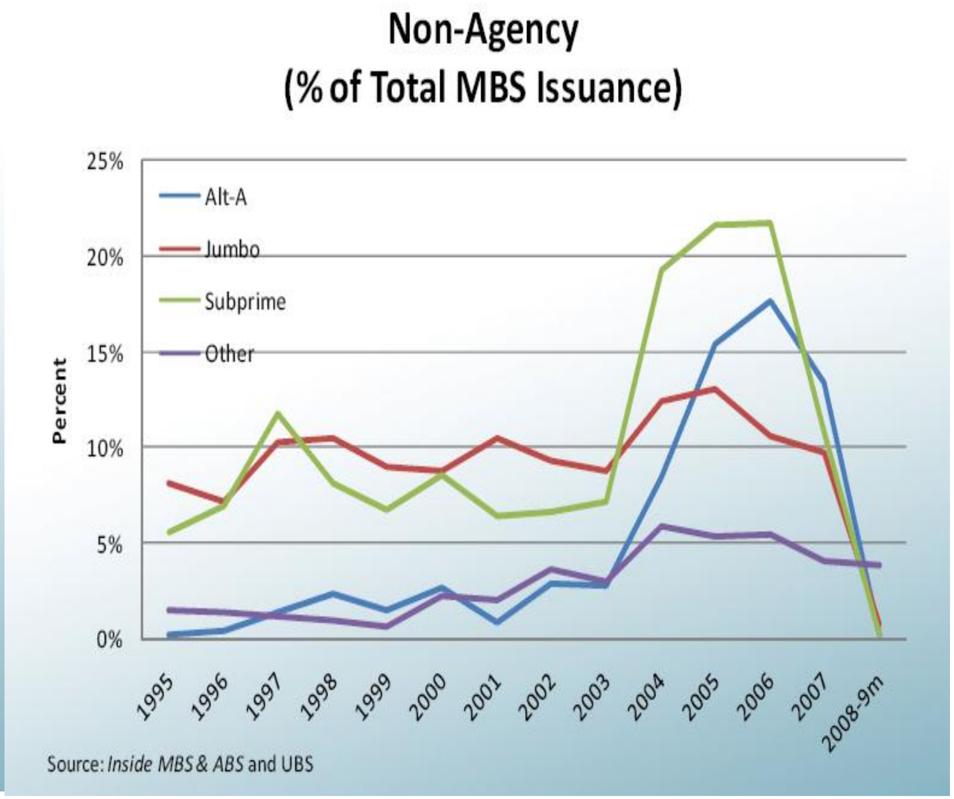
Post 3Q 2007

- Opportunists saw spreads over comparable agencies increase
- Seasoned AAA paper could be purchased at significant discounts
- Opportunists thought that spreads were due to short term liquidity issues

Gross MBS Issuance



Non-Agency MBS Issuance



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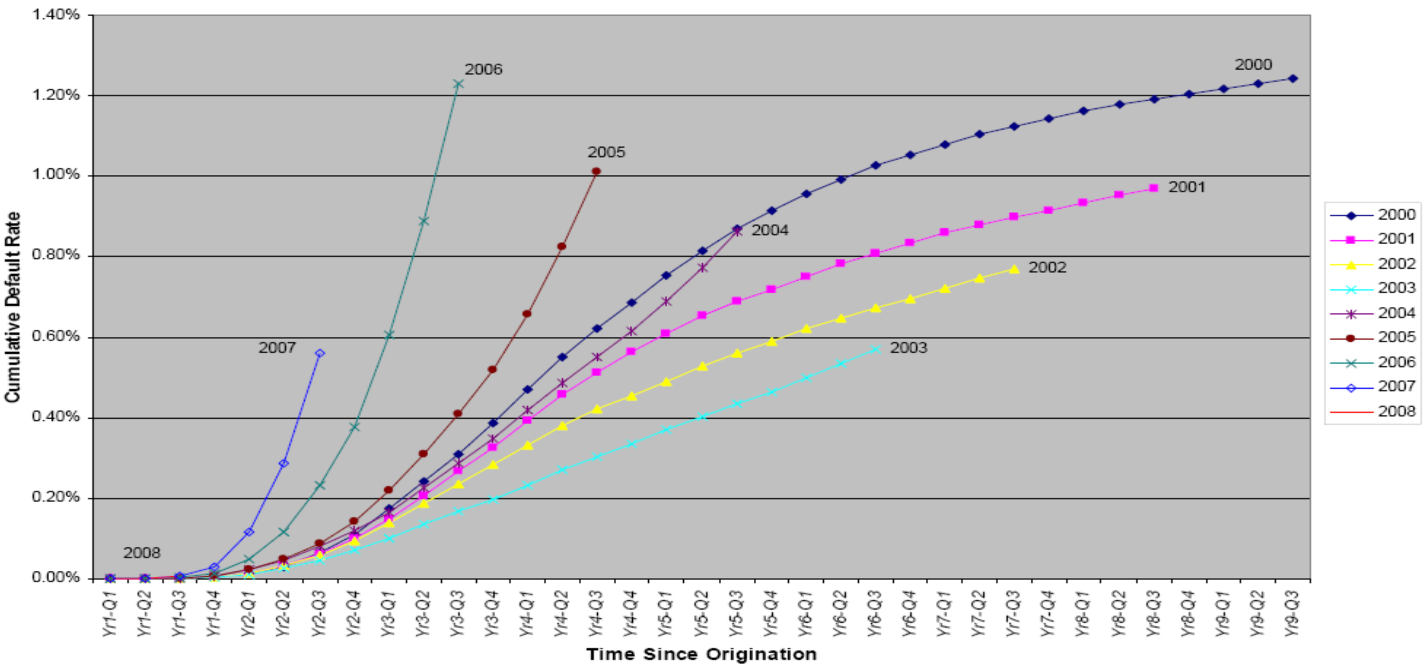
Cumulative Default Rates by Vintage

FannieMae



Note: Cumulative default rates include loans that have been liquidated other than through voluntary pay-off or repurchase by lenders and include loan foreclosures, preforeclosure sales, sales to third parties and deeds in lieu of foreclosure.

Consistent with industry trends, 2006 and 2007 vintages performing poorly. Defaults for the 2008 vintage through 2008 Q2 have been negligible.

Data as of September 30, 2008 is not necessarily indicative of the ultimate performance and are likely to change, perhaps materially, in future periods. 7

Capital Requirements for Direct Credit Substitutes

- Ratings Based Approach - allows institutions to assign risk weights to ABS and MBS based on external credit ratings from NRSROs (if split, must use lowest rating)
- If the security is rated more than one category below investment grade (e.g., below BB-) or unrated, the ratings based approach would not apply.
- In this case, the risk-weighted calculation is based on the book value of the security plus the pro rata portion of all the more senior positions it supports – subject to the low level recourse rule (i.e., bank's maximum contractual exposure)
- The low level exposure rule will result in the equivalent of a dollar-for-dollar capital requirement

The Ratings Based Approach

Long-term rating category	Examples	Risk Weight
Highest or second highest investment grade	**AAA, AA**	**20%**
Third highest investment grade	**A**	**50%**
Lowest investment grade	**BBB**	**100%**
One category below investment grade	**BB**	**200%**

Example:

Capital required against a $10 AA-rated PMBS = $10 * 20% = $2 * 8% = $.16

Gross Up Approach

- The risk-weighted asset calculation for the security is based on the amortized cost of the security (if not held for trading) plus the pro rata portion of all the more senior positions in the structure which it supports – subject to the low level recourse rule

- RWA = ((% of subordinate tranche owned * senior positions) + book value of bank's position) * risk-weight (%)

Example: Gross Up and Dollar-for-Dollar Methodology

Rating: A **$80**
Rating: CCC **$10**
Non-Rated **$10**

<u>Example 1 – Gross-Up Methodology – Bank owns 100% of tranche</u>

Bank owns 100% of CCC rated tranche ($10)
Risk-weighted asset calculation = $10 + $80 = $90 * 100% = $90
Minimum Capital charge = $90 * 8% = $7.2

Risk-weighting percentage = 900% [=$90/$10 * 100%]

<u>Example 2 – Gross-Up Methodology – Bank owns proportion of tranche</u>

Bank owns 50% of CCC rated tranche (Bank owns $5 of the $10 total tranche)
Risk-weighted asset calculation = $5 + [(.50) * ($80)] = $45
Minimum capital charge = $45 * 8% = $3.6
Risk-weighting percentage = 900% [=$45/$5*100%]

<u>Example of Dollar-for-Dollar Capital Charge</u>

Risk-weighted assets = $10 * 12.5x = $125
Minimum capital charge = $125 * 8% = $10
Risk-weighting percentage = 1,250%

Assessing Investment Securities in the current environment

- Management should thoroughly assess and understand the following:
  - Security's position in capital structure - Credit enhancements
  - Nature and Performance of underlying Collateral
  - Changes in the structure of payments under various scenarios
  - Allocation of losses under various scenarios
  - Market & Liquidity Risk associated with instrument
  - Capital requirements - change with the quality of the asset (i.e., NRSRO ratings)

SR 98-12: "Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities"

SR 04-9: "Uniform Agreement on the Classification of Assets and Appraisals of Securities held by Banks and Thrifts"

Supervisory Concerns

- Brokers are performing due diligence with limited challenges to assumptions
- High yields and depreciated values are attributed to market / liquidity risk rather than credit risk
- Lack of adequate policies, ongoing monitoring processes, and reporting to Board
- Lack of understanding of:
  - Structure
  - Capital Consequences
  - Credit Dynamics
  - Model Assumptions

Reporting Requirements: RC-R line item 50

Dollar amounts in thousands	(Column A) Face Value or Notional Amount	(Column B) Credit Equivalent Amount	(Column C) Allocation by Risk Weight Category 0%	(Column D) Allocation by Risk Weight Category 20%	(Column E) Allocation by Risk Weight Category 50%	(Column F) Allocation by Risk Weight Category 100%	
47. Risk participations in bankers acceptances acquired by the reporting institution..........	RCON3429	RCONB660	RCONB661	RCONB662		RCONB663	
	0	0	0	0		0	47.
48. Securities lent..........	RCON3433	RCONB664	RCONB665	RCONB666	RCONB667	RCONB668	
	0	0	0	0	0	0	48.
49. Retained recourse on small business obligations sold with recourse..........	RCONA250	RCONB669	RCONB670	RCONB671	RCONB672	RCONB673	
	0	0	0	0	0	0	49.
50. Recourse and direct credit substitutes (other than financial standby letters of credit) subject to the low-level exposure rule and residual interests subject to a dollar-for-dollar capital requirement..	RCONB541	RCONB542				RCONB543	
	0	0				0	50.
51. All other financial assets sold with recourse..........	RCONB675	RCONB676	RCONB677	RCONB678	RCONB679	RCONB680	
	0	0	0	0	0	0	51.
	RCONB681	RCONB682	RCONB683	RCONB684	RCONB685	RCONB686	

The March 2009 Call Report instructions were updated to provide detailed examples and tables to assist in this calculation. See "Treatment of Purchased Subordinated Securities that are Direct Credit Substitutes Not Eligible for the Ratings Based Approach: beginning on page RC-R-17 of the instructions.

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