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Basel Developments: A Renewed Focus on Credit Risk Mitigation Transactions and Regulatory Capital Arbitrage

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Transactions that reduce regulatory capital requirements for banks have recently come under media and regulatory scrutiny. The New York Times characterized them as a "trading sleight of hand." The Basel Committee on Banking Supervision has proposed limiting the ways in which capital requirements can be reduced by such transactions. This client note discusses the new Basel proposals in light of prior guidance published by Basel and the Federal Reserve. As banks seek ways to meet heightened capital requirements and surcharges that are being implemented, they may find greater difficulties in reducing their exposures.

Background

On March 22, 2013, the Basel Committee on Banking Supervision ("Basel Committee") published a proposal (the "Proposal") intended to reduce incentives for regulatory capital arbitrage related to certain credit risk mitigation ("CRM") transactions. The Proposal is intended to ensure that the costs of credit protection are recognized in regulatory capital. If adopted by national supervisors, this proposal could limit banks' ability to reduce risk weighted assets ("RWA") at a time when Basel III's higher capital requirements and surcharges for systemically important financial institutions are being implemented. Examples of transactions that might be caught by these new requirements, specified in the technical guidance (the "Technical Guidance") that accompanies the Proposal, include the purchase of credit protection on securitization exposures and single name corporate exposures. Under Basel II, CRM transactions may be used to reduce capital requirements, subject to certain conditions.[1] Basel III did not amend the Basel II approach to CRM transactions.[2]

In December 2011, the Basel Committee issued a newsletter noting the potential for regulatory capital arbitrage when (i) there is a delay in recognizing losses and the costs of protection in earnings while (ii) the bank receives an immediate regulatory capital benefit in the form of a lower risk weight on an exposure on which it is nominally transferring risk.[3] The Basel Committee noted that opportunities for such arbitrage are particularly relevant to securitization transactions, where the difference in the risk weight before and after buying protection can be significant, but that arbitrage opportunities also exist for other types of transactions.

At the time of the 2011 publication, the Basel Committee announced that it would continue to monitor developments with respect to such transactions and consider imposing a new Pillar 1 minimum capital requirement if necessary. The Proposal will implement this Pillar 1 approach.

In the US, the Federal Reserve preceded the Basel Committee's December 2011 newsletter with a Supervisory Letter issued on January 25, 2011 ("SR 11-1").[4] SR 11-1 stated that Federal Reserve supervisors will scrutinize high-cost CRM transactions and noted that, in some cases, the Federal Reserve may determine "that a transaction should not be recognized as a guarantee for risk-based capital purposes."[5]

The Proposal

The Proposal would add to provisions of the Basel II framework that require banks to calculate the present value of premia for credit protection purchased where such value has not yet been recognized in earnings. The present value would then be considered as an exposure amount of the protection-purchasing bank and be assigned a 1,250% risk weight (in effect, a full deduction of the present value amount from regulatory capital). Under the proposal, exposures with a risk weight of greater than 150% at the time credit protection is put in place would be considered material. However, the Proposal would provide supervisors with the power to determine that the cost of protection is material even if the risk weight is below or equal to this threshold. The Technical Guidance provides the following two examples of where premia may be considered material even where the risk weight of the position being protected would be less than or equal to 150% in the absence of credit protection:

- There is a significant rebate mechanism. Such a rebate mechanism could include where premiums not needed to cover losses are rebated to the bank on the maturity of the protection.
- The exposure is from securitization assets where the market value is significantly less than book value.

1 Basel Comm. on Banking Supervision ("Basel Comm."), *International Convergence of Capital Measurement and Capital Standards*, at ¶ 140 (Jun. 2006) ("Basel II"). The US federal banking regulators proposed regulations that would generally be consistent with the Basel II approach to credit risk mitigation transactions. *See* Office of the Comptroller of the Currency, Fed. Reserve Sys., and Fed. Deposit Ins. Corp., *Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements*, 77 Fed. Reg. 52,888, 52,907-52,908 (Aug. 2012).

2 You may refer to for Shearman & Sterling's client publication regarding implementation of the Basel III framework in the US and EU here.

3 Basel Comm., *High Cost Credit Protection*, Basel Comm. Newsletter No. 16 (Dec. 2011).

4 Federal Reserve, *Impact of High-Cost Credit Protection Transactions on the Assessment of Capital Adequacy*, SR 11-1 (Jan. 2011).

5 *Id.*

The Proposal raises the issue of whether additional exemptions, in addition to the 150% risk-weight threshold, should be considered, such as exemptions for exposures guaranteed by government entities and trade finance transactions with guarantees.

In relation to securtization, the Proposal would require that the material costs of credit protection be considered in the analysis required to determine whether significant credit risk of a securitized exposure has been transferred to a third party, which is necessary to de-recognize the securitized exposure for capital purposes.

The Proposal also includes technical guidance regarding:

- calculation of the present value of the cost of protection;
- examples of significant risk transfer assessments;
- situations of whether, and how, losses that are already recognized on an exposure, through the reduction of the on-balance sheet value of the exposure and in earnings, should be considered in evaluating the costs of the protection relative to the carrying value of the exposure; and
- treatment of maturity mismatches (the guidance would allow supervisors to consider an implied credit protection premium to cover the maturity mismatch).

2011 Guidance

The Basel Committee's 2011 newsletter included guidance for evaluating the degree of credit risk mitigation or credit risk transfer of a transaction. The Federal Reserve's SR 11-1 is consistent with this guidance. As noted above, the Proposal shows that supervisors are focused on the use of regulatory capital arbitrage transactions to reduce RWAs. Thus, banks may want to consider this prior guidance carefully when structuring CRM transactions.

The 2011 newsletter said that in evaluating the degree of credit risk mitigation or credit risk transfer of a transaction, banks should consider the following factors:

- a comparison of the present value of premiums and other costs not yet recognized in capital relative to expected losses of the protected exposures over a variety of stress scenarios;
- the pricing of the transaction relative to market prices, including appropriate consideration of non-cash premium payments;
- the timing of payments under the transaction by the protection buyer, including potential timing differences between the bank's provisioning for or write downs of the protected exposures and payments by the protection seller;
- a review of applicable call dates to assess the likely duration of the credit protection relative to the potential timing of future credit losses;
- an analysis of whether certain circumstances could lead to the bank's increased reliance on the counterparty at the same time that the counterparty's ability to meet its obligations is weakened;
- an analysis of whether the bank can prudently afford the premiums given its earnings, capital, and overall financial condition; and
- a review of any internal memos or records outlining the rationale for the transaction and the bank's analysis of the anticipated costs and benefits of the transaction.

Further, the 2011 newsletter said that supervisors also should focus more attention on credit protection transactions with the following characteristics:

- Protection premiums are high relative to the amount of the exposures being protected; for example, when the cost of protection over the life of the protection contract approaches, equals, or exceeds the amount of the exposures for which protection is being purchased.
- Rebate mechanisms (i.e., where the protection seller agrees to refund parts of the premium to the protection buyer according to the performance/deterioration of the protected exposure) are an indication of excessive premium and, consequently, regulatory arbitrage.
- Transactions where the exposure being protected has not been fair valued and losses on the exposure have not been recognized in earnings.
- Transactions where the potential for reduction in risk weights or regulatory capital as a result of the transaction is greatest.
- Protection premiums are not proportional to the exposures being protected.
- Structural features of the transaction that can increase the total cost of credit risk mitigation.

Conclusion

The Proposal shows that banking regulators are focused on the use of regulatory capital arbigtrage transactions to reduce RWAs. The proposals could potentially have significant effects for the credit default swap and securitization markets. Even though the Proposal is not yet part of the Basel accords, and would require implementation on a national basis to become law, financial regulators may begin to scrutinize these transactions, and therefore banks should carefully consider the guidance described above when contemplating how to structure any affected risk mitigation transactions.

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