BOARD OF GOVERNORS

OF THE

FEDERAL RESERVE SYSTEM

WASHINGTON, D.C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

BASEL COORDINATION COMMITTEE
(BCC) BULLETIN

BCC 13-2

March 21, 2013

SUBJECT: Excluding Exposures to Investment Firms from the Definition of "Traditional Securitization"

Background

Under the advanced approaches risk-based capital rule (rule),[1] the definition of traditional securitization captures a broader set of exposures than those commonly understood by banking organizations and other market participants to be a securitization.[2] For example, certain exposures to regulated pension funds or investment firms registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (more specifically, mutual funds), as well as certain exposures to other investment firms, may meet this definition, because exposures to these entities often involve the tranching of credit risk. As indicated in the preamble to the rule, the Board deliberately defined traditional securitization broadly in order "to create a level playing field across the securitization, credit derivative, and other financial markets."[3]

If an exposure meets the definition of a traditional securitization under the rule, a banking organization must use the hierarchy of approaches for securitization exposures to determine the capital requirement associated with the exposure. In cases when a securitization exposure is unrated and the banking organization lacks information necessary to use another applicable approach for securitization exposures, the banking organization may be required to deduct the securitization exposure from its regulatory capital. This requirement to deduct an exposure from regulatory capital will often be the case for exposures to pension funds and mutual funds, as well as exposures to other investment firms. In contrast, if such exposures were considered equity or wholesale exposures under the rule, they could qualify for a more preferential risk weight treatment (for example, a 100 percent, 300 percent, or 400 percent risk weight under the framework for equity exposures).

[1] 12 CFR part 208, appendix F, and 12 CFR part 225, appendix G.

[2] See appendix A to view the definition of a traditional securitization under the rule.

[3] 72 *Fed. Reg.* 69327 (December 7, 2007).

After gaining more experience under the rule with exposures to pension funds, mutual funds, and other investment funds, Federal Reserve staff has come to the view that exposures to certain of these entities generally do not have a risk profile consistent with deduction from regulatory capital. In addition, with respect to exposures to investment firms that exercise substantially unfettered control over their underlying assets, staff has identified criteria regarding their leverage, risk profile, and economic substance that is indicative of exposures that should not be treated as traditional securitizations. Accordingly, staff is issuing this guidance to clarify expectations around the treatment by banking organizations under the rule of traditional securitization exposures involving (1) pension funds, mutual funds, and certain other investment funds, and (2) investment firms that exercise unfettered control over their underlying exposures.

1. Implementation Guidance for Pension Funds, Registered Investment Companies, and Other Investment Funds

Under the rule, the Board may require a banking organization to assign a different risk-weighted asset amount to an exposure if the Board determines that the risk-weight is not commensurate with the risks associated with those exposures.[4]

As discussed above, staff believes that the risks of exposures to regulated pension and mutual funds and exposures to certain other investment funds are more appropriately captured by the wholesale and equity frameworks under the rule. In the notice[5] of proposed rulemaking issued by the Board and the other banking agencies that would modify certain aspects of the rule and related definitions, the agencies proposed to exclude exposures to these types of funds from the definition of "traditional securitization." If this proposal is finalized by the Board, exposures to these types of funds would no longer be securitization exposures for the purposes of the rule.

As an interim solution while this proposed rule change is pending, Federal Reserve staff would recommend that the Board, using its reservation of authority, determine that an exposure to an investment firm not be considered a traditional securitization if the exposure is to a pension fund regulated under the Employee Retirement Income and Security Act (29 U.S.C. 1002) or its foreign equivalent, an investment fund as defined under the rule,[6] a collective investment fund,[7] or a fund registered with the Securities and Exchange Commission under the Investment Company Act of 1940 or its foreign equivalent.[8] Instead, Board staff would recommend that

[4] 12 CFR part 208, appendix F, section 1(c)(2)(i), and 12 CFR part 225, appendix G, section 1(c)(2)(i).

[5] 77 *Fed. Reg.* 52978 (August 30, 2012)

[6] Under the rule, investment fund means a company: (i) all or substantially all of the assets of which are financial assets; and (ii) that has no material liabilities.

[7] Collective investment funds are defined in 12 CFR 208.34 as funds held by a state member bank as fiduciary and, consistent with local law, invested collectively as follows: (i) in a common trust fund maintained by such bank exclusively for the collective investment and reinvestment of monies contributed thereto by the bank in its capacity as trustee, executor, administrator, guardian, or custodian under the Uniform Gifts to Minors Act; or (ii) in a fund consisting solely of assets of retirement, pension, profit sharing, stock bonus or similar trusts which are exempt from federal income taxation under the Internal Revenue Code (Title 26 of the U.S. Code).

[8] In connection with the notices of proposed rulemaking that would implement Basel III, the Board has proposed to exclude from the definition of "traditional securitization" exposures to pension funds and investment companies registered under the Investment Company Act of 1940. 15 U.S.C. 80a–3(a).

such exposures be treated as wholesale or equity exposures, as applicable.[9] Staff would also recommend that the Board specify that this determination is effective only while the relevant notice of proposed rulemaking is pending (that is, the Board has not withdrawn or finalized the proposal), and that any modification to the proposal producing a different result would govern the treatment of these exposures.

2. Implementation Guidance for Investment Companies that Exercise Substantially Unfettered Control

The rule also allows the Board to determine that a transaction in which the underlying exposures are owned by an investment firm that exercises substantially unfettered control over the size and composition of its assets, liabilities, and off-balance sheet exposures is not a traditional securitization based on the transaction's leverage, risk profile, or economic substance.[10] Based on experience with exposures involving certain investment firms (other than regulated pension funds, mutual funds, or the foreign equivalent), Board staff would recommend that the Board determine that a full recourse exposure to an investment firm would not be considered a traditional securitization based on the transaction's leverage, risk profile, and economic substance if:

- The investment firm is actively managed by one or more investment advisers such that the composition of its investment portfolio can change over time in furtherance of the firm's investment strategy, and is not static;
- The investment firm, as managed by its investment adviser, retains broad discretion to execute or change the manner in which it executes its investment strategy, including with respect to the composition of its investment portfolio and the type and amount of leverage employed in its investment strategy;
- The investment firm, as managed by its investment adviser, retains broad discretion to use a variety of instruments and transactions to execute its investment strategy;
- The investment firm, as managed by its investment adviser, has the broad discretion and ability to control the size of the firm through the issuance of variable amounts of debt, or through the issuance and redemption of shares or ownership interests; and
- The investment firm, as managed by its investment adviser, retains broad discretion to distribute or reinvest cash proceeds generated by the firm's underlying assets.

If these criteria are satisfied, a banking organization would be allowed to treat the exposure as an equity or wholesale exposure under the rule. If these criteria are not satisfied, a banking organization would be required to otherwise demonstrate to the satisfaction of the Federal Reserve that the transaction should not be considered a traditional securitization.

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[9] Of note, unlike equity exposures excluded under paragraph 8 of the definition of traditional securitizations, excluded exposures to a regulated pension fund, an investment company, or the foreign equivalent would not be subject to a 600 percent risk weight under section 51(b)(6) of the advanced approaches rule.

[10] 12 CFR part 208, appendix F, section 2, and 12 CFR part 225, appendix G, section 2.

Appendix A: Traditional Securitization under the Rule

Under the rule (12 CFR part 208, appendix F, and 12 CFR part 225, appendix G), a traditional securitization means a transaction in which:

1) All or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties other than through the use of credit derivatives or guarantees;
2) The credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority;
3) Performance of the securitization exposures depends upon the performance of the underlying exposures;
4) All or substantially all of the underlying exposures are financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, mortgage-backed securities, other debt securities, or equity securities);
5) The underlying exposures are not owned by an operating company;
6) The underlying exposures are not owned by a small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682); and
7) The underlying exposures are not owned by a firm an investment in which qualifies as a community development investment under 12 U.S.C. 24(Eleventh).
8) The Federal Reserve may determine that a transaction in which the underlying exposures are owned by an investment firm that exercises substantially unfettered control over the size and composition of its assets, liabilities, and off-balance sheet exposures is not a traditional securitization based on the transaction’s leverage, risk profile, or economic substance.
9) The Federal Reserve may deem a transaction that meets the definition of a traditional securitization, notwithstanding paragraph (5), (6), or (7) of this definition, to be a traditional securitization based on the transaction’s leverage, risk profile, or economic substance.