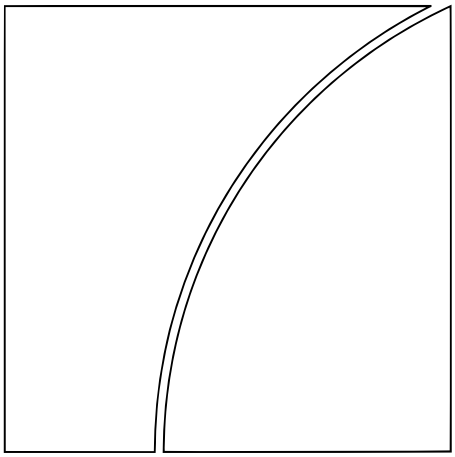
Basel Committee on Banking Supervision

CRE

Calculation of RWA for credit risk

CRE43



Securitisation: Internal assessment approach (SEC-IAA)

This chapter describes how to calculate capital requirements for short-term securitisation exposures according to the internal assessment by the bank of the credit quality of the exposures (SEC-IAA).

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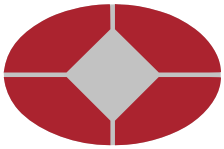
First version in the format of the consolidated framework.



BANK FOR INTERNATIONAL SETTLEMENTS

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Internal assessment approach (SEC-IAA)

43.1

Subject to supervisory approval, a bank may use its internal assessments of the credit quality of its securitisation exposures extended to ABCP programmes (eg liquidity facilities and credit enhancements) provided that the bank has at least one approved IRB model (which does not need to be applicable to the securitised exposures) and if the bank's internal assessment process meets the operational requirements set out below. Internal assessments of exposures provided to ABCP programmes must be mapped to equivalent external ratings of an ECAI. Those rating equivalents are used to determine the appropriate risk weights under the SEC-ERBA for the exposures.

43.2

A bank's internal assessment process must meet the following operational requirements in order to use internal assessments in determining the IRB capital requirement arising from liquidity facilities, credit enhancements, or other exposures extended to an ABCP programme:

1. For the unrated exposure to qualify for the internal assessment approach (SEC-IAA), the ABCP must be externally rated. The ABCP itself is subject to the SEC-ERBA.
2. The internal assessment of the credit quality of a securitisation exposure to the ABCP programme must be based on ECAI criteria for the asset type purchased, and must be the equivalent of at least investment grade when initially assigned to an exposure. In addition, the internal assessment must be used in the bank's internal risk management processes, including management information and economic capital systems, and generally must meet all the relevant requirements of the IRB framework.
3. In order for banks to use the SEC-IAA, their supervisors must be satisfied
    1. that the ECAI meets the ECAI eligibility criteria outlined in CRE21 and
    2. with the ECAI rating methodologies used in the process.
4. Banks demonstrate to the satisfaction of their supervisors how these internal assessments correspond to the relevant ECAI's standards. For instance, when calculating the credit enhancement level in the context of the SEC-IAA, supervisors may, if warranted, disallow on a full or partial basis any seller-provided recourse guarantees or excess spread, or any other first-loss credit enhancements that provide limited protection to the bank.
5. The bank's internal assessment process must identify gradations of risk. Internal assessments must correspond to the external ratings of ECAIs so that supervisors can determine which internal assessment corresponds to each external rating category of the ECAIs.
6. The bank's internal assessment process, particularly the stress factors for determining credit enhancement requirements, must be at least as conservative as the publicly available rating criteria of the major ECAIs that are externally rating the ABCP programme's commercial paper for the asset type being purchased by the programme. However, banks should consider, to some extent, all publicly available ECAI rating methodologies in developing their internal assessments.
    1. In the case where the commercial paper issued by an ABCP programme is externally rated by two or more ECAIs and the different ECAIs' benchmark stress factors require different levels of credit enhancement to achieve the same external rating equivalent, the bank must apply the ECAI stress factor that requires the most conservative or highest level of credit protection. For example, if one ECAI required enhancement of 2.5 to 3.5 times historical losses for an asset type to

obtain a single A rating equivalent and another required two to three times historical losses, the bank must use the higher range of stress factors in determining the appropriate level of seller-provided credit enhancement.

2. When selecting ECAIs to externally rate an ABCP, a bank must not choose only those ECAIs that generally have relatively less restrictive rating methodologies. In addition, if there are changes in the methodology of one of the selected ECAIs, including the stress factors, that adversely affect the external rating of the programme's commercial paper, then the revised rating methodology must be considered in evaluating whether the internal assessments assigned to ABCP programme exposures are in need of revision.
3. A bank cannot utilise an ECAI's rating methodology to derive an internal assessment if the ECAI's process or rating criteria are not publicly available. However, banks should consider the non-publicly available methodology - to the extent that they have access to such information - in developing their internal assessments, particularly if it is more conservative than the publicly available criteria.
4. In general, if the ECAI rating methodologies for an asset or exposure are not publicly available, then the IAA may not be used. However, in certain instances - for example, for new or uniquely structured transactions, which are not currently addressed by the rating criteria of an ECAI rating the programme's commercial paper - a bank may discuss the specific transaction with its supervisor to determine whether the IAA may be applied to the related exposures

7. Internal or external auditors, an ECAI, or the bank's internal credit review or risk management function must perform regular reviews of the internal assessment process and assess the validity of those internal assessments. If the bank's internal audit, credit review or risk management functions perform the reviews of the internal assessment process, then these functions must be independent of the ABCP programme business line, as well as the underlying customer relationships.
8. The bank must track the performance of its internal assessments over time to evaluate the performance of the assigned internal assessments and make adjustments, as necessary, to its assessment process when the performance of the exposures routinely diverges from the assigned internal assessments on those exposures.
9. The ABCP programme must have credit and investment guidelines, ie underwriting standards, for the ABCP programme. In the consideration of an asset purchase, the ABCP programme (ie the programme administrator) should develop an outline of the structure of the purchase transaction. Factors that should be discussed include the type of asset being purchased; type and monetary value of the exposures arising from the provision of liquidity facilities and credit enhancements; loss waterfall; and legal and economic isolation of the transferred assets from the entity selling the assets.
10. A credit analysis of the asset seller's risk profile must be performed and should consider, for example, past and expected future financial performance; current market position; expected future competitiveness; leverage, cash flow and interest coverage; and debt rating. In addition, a review of the seller's underwriting standards, servicing capabilities and collection processes should be performed.
11. The ABCP programme's underwriting policy must establish minimum asset eligibility criteria that, among other things:
    1. exclude the purchase of assets that are significantly past due or defaulted;
    2. limit excess concentration to individual obligor or geographical area; and
    3. limit the tenor of the assets to be purchased.
12. The ABCP programme should have collection processes established that consider the

operational capability and credit quality of the servicer. The programme should mitigate to the extent possible seller/servicer risk through various methods, such as triggers based on current credit quality that would preclude commingling of funds and impose lockbox arrangements that would help ensure the continuity of payments to the ABCP programme.

13. The aggregate estimate of loss on an asset pool that the ABCP programme is considering purchasing must consider all sources of potential risk, such as credit and dilution risk. If the seller-provided credit enhancement is sized based on only credit-related losses, then a separate reserve should be established for dilution risk, if dilution risk is material for the particular exposure pool. In addition, in sizing the required enhancement level, the bank should review several years of historical information, including losses, delinquencies, dilutions and the turnover rate of the receivables. Furthermore, the bank should evaluate the characteristics of the underlying asset pool (eg weighted-average credit score) and should identify any concentrations to an individual obligor or geographical region and the granularity of the asset pool.
14. The ABCP programme must incorporate structural features into the purchase of assets in order to mitigate potential credit deterioration of the underlying portfolio. Such features may include wind-down triggers specific to a pool of exposures.

43.3

The exposure amount of the securitisation exposure to the ABCP programme must be assigned to the risk weight in the SEC-ERBA appropriate to the credit rating equivalent assigned to the bank's exposure.

43.4

If a bank's internal assessment process is no longer considered adequate, the bank's supervisor may preclude the bank from applying the SEC-IAA to its ABCP exposures, both existing and newly originated, for determining the appropriate capital treatment until the bank has remedied the deficiencies. In this instance, the bank must revert to the SEC-SA described in CRE41.1 to CRE41.15.