**Financial Institution Letter**  
**FIL-26-2005**  
**March 31, 2005**

## CAPITAL STANDARDS

**Supervisory Guidance on the Use of Internal Risk Ratings for Assigning Risk-Based Capital on Exposures to Asset-Backed Commercial Paper Programs**

**Summary:** The FDIC, along with the other federal banking and thrift regulatory agencies, has issued the attached supervisory guidance that explains the qualifying criteria for using an internal risk-rating system for assigning risk-based capital on exposures to asset-backed commercial paper (ABCP) programs. This guidance supplements the final rule revising the regulatory capital treatment of recourse, direct credit substitutes and residual interests in asset securitizations that was issued in November of 2001 (“Securitization Capital Rule” – see FIL-99-2001).

<table>
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<tr>
<th>Distribution:</th>
<th>FDIC-Supervised Banks (Commercial and Savings)</th>
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</table>
| **Suggested Routing:** | Chief Executive Officer  
Chief Financial Officer  
Chief Accounting Officer |
| **Related Topics:** | Assessment of Internal Risk Ratings Systems  
ABCP Programs  
Risk-Based Capital Rules – Part 325 |
| **Attachment:** | Supervisory guidance to assist in the determination of the appropriate risk-based capital treatment to be applied to direct credit substitutes issued in connection with ABCP programs |
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**Highlights:**

The supervisory guidance:

- Provides further clarification on the requirements and conditions that must be met in order to qualify for the internal risk-rating system approach as specified in the Securitization Capital Rule.

- Provides implementing standards to be used in evaluating whether the bank’s internal risk-rating system for ABCP exposures reasonably corresponds to the methodologies used by the ratings agencies in assigning external credit ratings.

- Provides a framework for supervisors to determine the appropriate risk-based capital treatment for unrated direct credit substitutes provided to ABCP programs, using a “weakest link” method.

- Generally applies to large banks that extend credit enhancements to ABCP programs.
CAPITAL STANDARDS

Supervisory Guidance on the Use of Internal Risk Ratings for Assigning Risk-Based Capital on Exposures to Asset-Backed Commercial Paper Programs

The Federal Deposit Insurance Corporation (FDIC), along with the federal bank and thrift regulatory agencies, has issued the attached guidance explaining the qualifying criteria that must be satisfied in order to use internal risk ratings for assigning risk-based capital requirements on credit enhancements provided by banks to asset-backed commercial paper (ABCP) programs. The document provides banks with the guidance necessary to implement the requirements set forth in the Securitization Capital Rule, which revised the regulatory capital treatment of recourse, direct credit substitutes and residual interests in asset securitizations in November of 2001 (see FIL-99-2001).

In the Securitization Capital Rule, banks were given permission to use internal risk ratings to assign regulatory capital requirements to unrated direct credit substitutes provided to ABCP programs, subject to the bank demonstrating to the satisfaction of its primary federal regulator that its internal credit risk-rating system is adequate. This guidance provides the standards that should be considered in determining whether the internal risk-rating system meets the conditions set forth in the Securitization Capital Rule.

The guidance provides an analytical framework to assess broadly the risk characteristics of direct credit substitutes that banks provide to ABCP programs. Additionally, the guidance sets forth supervisory expectations governing the internal risk-rating system and sound risk-management practices that need to be followed by banks. Banks that use the internal risk-rating approach must have in place an established risk-rating system for ABCP exposures.

Under the Securitization Capital Rule, banks that meet the standards set forth in the supervisory guidance will be allowed to map their internal risk ratings to external ratings equivalents. This guidance organizes external credit rating equivalents into the following three ratings categories: investment grade credit risk (BBB- and above) is subject to a 100 percent risk weight that is applied to the face amount of the exposure; high non-investment grade credit risk (BB+ through BB-) is subject to a 200 percent risk weight that is applied to the face amount of the exposure; and low non-investment grade credit risk (below BB-) is subject to the “gross-up” approach, which requires the bank to hold capital on the unrated position plus all of the more senior positions in the structure.

This guidance is limited to evaluating the internal rating systems utilized by a bank in connection with ABCP programs as prescribed in the Securitization Capital Rule and will
have no bearing on the overall appropriateness of a bank’s internal risk-rating system for purposes of achieving compliance with the standards set forth in the Basel II Capital Accord or in the domestic implementation of the Basel II standards.

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