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30 April 2001

Mr Brian Gray  
Executive General Manager  
Policy, Research and Consulting  
Australian Prudential Regulatory Authority  
Level 26, 400 George Street  
SYDNEY NSW 2000

Dear Mr Gray

Submission regarding the Basel Committee on Banking Supervision's Second Consultative Package on the New Basel Capital Accord (January 2001) ("Second Consultative Package")

I am writing to you in my capacity as Convenor of the Regulatory Issues Committee of the Australian Securitisation Forum ("ASF"). The ASF is the peak body representing the securitisation industry in Australia.

I enclose the formal submission of the ASF to the Second Consultative Package, for which industry comment was to be provided to the Australian Prudential Regulation Authority ("APRA") by 30 April 2001.

The submission specifically addresses the issues raised in the "Consultative Document – Asset Securitisation" and has been coordinated through the Regulatory Issues Committee of the ASF with further consultation provided from a broad range of industry participant ASF members as listed in the Annexure to the submission.

The ASF would be happy to discuss the recommendations contained in the attached submission with you in more depth if you feel this is necessary. To arrange such a discussion, or if you have any queries in relation to the submission, please contact me on (02) 9229 9976.

Yours sincerely

**Phillip Vernon**  
Convenor  
Regulatory Issues Committee  
Australian Securitisation Forum



**Australian Securitisation Forum**

**Submission to the  
Basel Committee on Banking Supervision**

**Consultative Document for the New  
Basel Capital Accord (January 2001)**

**31 May 2001**

## **1. Introduction**

- 1.1. This submission contains a response by the Australian Securitisation Forum (ASF) to the Basel Committee on Banking Supervision's (Basel Committee) Second Consultative Package on the New Basel Capital Accord, dated January 2001 (Second Consultative Package).
- 1.2. The ASF wishes to table this submission with the Basel Committee for its consideration in relation to the Supporting Document in the Second Consultative Package entitled "Consultative Document – Asset Securitisation".
- 1.3. This submission was also tabled with the Australian Prudential Regulation Authority (APRA), 30 April 2001.

## **2. The Australian Securitisation Forum**

- 2.1. The Australian Securitisation Forum (ASF) is the peak body representing the securitisation industry in Australia. It has been in existence for over 10 years and its purpose is to promote the development of securitisation in Australia.
- 2.2. The ASF's members include representatives from major banks, investment banks, insurers, rating agencies, trustees and legal and accounting firms.
- 2.3. A sub-committee of the ASF was formed to consider the Second Consultative Package and to prepare this Submission. A list of member organisations of that sub-committee is attached as Appendix A.

## **3. Summary**

- 3.1. As the Basel Committee recognises, both traditional and synthetic securitisation are balance sheet management tools that can provide a number of benefits to financial institutions, be they acting as originator/seller, investor or sponsor (ongoing reference will be to "banks" for consistency with the Second Consultative Package).
- 3.2. The ASF supports the general concepts proposed by the Basel Committee and its approach to aligning a financial institution's minimum capital requirements with its overall risk profile. The expansion of the internal rating based approaches is a further positive step supported by the ASF.
- 3.3. The ASF recognises that where a bank takes on risks through its involvement in securitisation that the bank should hold capital commensurate with those risks. However, the ASF does not support the Basel Committee's conservative approach to securitisation, both in the traditional sense and synthetically, vis a vis other exposures of a similar nature (eg direct rated corporate exposures) on the basis that this conservative approach creates clear disincentives for banks to become involved in securitisation.
- 3.4. To ensure that securitisation continues to be available as a risk management tool for banks, the ASF recommends the Basel Committee apply a consistent approach across similar risks. For example, for banks applying the Internal Rating Based Approach (IRB), this means allowing the securitisation related exposures to be assessed within a bank's IRB model in line with similar exposures. The incentive for using securitisation for regulatory capital arbitrage will be removed as the on balance sheet exposures attract a capital charge more reflective of the economic risk and banks are only able to reduce the capital held to the extent there is true risk transferral.
- 3.5. The ASF believes any potential concerns relating to structural or moral risk associated with securitisation are addressed adequately through the proposed operational requirements (paragraph 90) and disclosures presently made within securitisation structure documentation. The ASF does not therefore support any differentiation in the treatment of securitisation exposures between banks acting as originators, investors or sponsors.
- 3.6. The ASF consider that the objectives of the Basel Committee in relation to synthetic securitisation are consistent with the overall economic incentives of synthetic securitisation. The ASF believes

however, there is a need to ensure that measures implemented to reduce the incentives for regulatory arbitrage do not make it uneconomic to carry out portfolio risk management through the use of synthetic securitisation.

#### 4. Specific Comment

##### 4.1. Explicit Risks in Traditional Securitisation – Standardised Approach

###### 4.1.1. Paragraph 13 – Minimum operational requirements for achieving a clean break

The ASF is supportive of the Basel Committee's objective of ensuring that clean up calls are set at relatively small percentage levels. The ASF supports APRA's current APS 120 requirement for clean up calls to be no greater than 10% of the maximum value of assets held by the vehicle or otherwise subject to prior APRA consent.

The economic benefits attached to maintaining less than 10% of the original issue can be far outweighed by the fixed costs and fixed operational activities associated with maintaining any ABS transaction, regardless of its size, eg audit/accounting, rating agency surveillance. Despite this 10%, the ASF supports the need for flexibility to enable banks to set clean up calls at less than 10% without reference to APRA.

###### 4.1.2. Paragraph 16 – Minimum capital requirements for credit enhancements

The ASF does not support the Basel Committee's approach to second loss enhancements. In particular the ASF does not support the Basel Committee's requirement that first loss protection must be sufficient to elevate the credit quality of the second loss enhancement to an investment grade level before treating that second loss enhancement as a direct credit substitute.

The ASF supports APRA's current guidelines which permit a bank to provide both first and second loss facilities in the same transaction, to treat them as separate facilities and to treat the second loss facility as a direct credit substitute provided that:

- (a) the facilities are separately documented and clearly function separately;
- (b) the second loss facility is protected by a "substantial" first-loss facility (ie. where the first-loss facility covers a multiple of historical losses or worst-case loss and the adequacy is assessed on an arm's length basis by the relevant bank, including an assessment of opinions from reputable third parties such as rating agencies concerning the adequacy of the first-loss facility);
- (c) the second loss can only be drawn after the first-loss facility has been completely exhausted;
- (d) the second loss cover only extends to losses beyond those covered by the first-loss facility; and
- (e) the second loss facility is made up of subordinated securities (or some form of marketable credit enhancement) which could be readily transferred by the bank at any time.

###### 4.1.3. Paragraphs 26 and 27 – Minimum capital requirements for investments in ABS

The ASF recommends revised risk weightings for investments in ABS in line with those applied to unsecured rated debt, as the differential is unwarranted and disadvantageous to securitisation.

###### 4.1.4. Paragraphs 29 and 30 – Treatment of unrated securitisations

The ASF supports the “look through” approach proposed by the Basel Committee. The ASF questions however, the approach to investments in mezzanine or subordinated debt (paragraph 30). The ASF believes a risk weighting should be applied commensurate with the applicable risk weighting of the underlying assets, regardless of whether the debt is senior, mezzanine or subordinated.

The ASF does not support the differential between the treatment of unrated subordinated debt between originating banks (deducted from capital) and sponsoring banks (100% risk weight). Any such investment is provided on an individual basis and documented separately. Obligations are clearly disclosed and the underlying risks are the same regardless of whether the investment is made by an originator or sponsor.

The ASF recommends the look through approach be extended to unrated second loss enhancements and other unrated exposures such as liquidity facilities, interest rate and cross currency swaps and underwriting facilities. For the capital charge to reflect a banks underlying risk position, the risk weightings applied should have regard to how the facility ranks in the event the securitisation structure is wound up. For example, facilities that rank equally with AAA rated securities should attract a 20% risk weighting, while a facility that ranks equally with A+ rated securities should attract a 50% risk weighting. Where such facilities do not rank equally with issued securities, for example, they rank after AAA securities but before BBB securities, they should attract the risk weighting applicable to the next ranking security.

The ASF also recommends banks investing in unrated holdings be able to utilise the IRB approach to determine a capital charge. This could be achieved through either calibration against other rated tranches, looking through to the rating of assets in the underlying portfolio or an adaptation of the sliding scale approach, depending on the specific circumstances of the transaction.

#### 4.2. The treatment for sponsoring banks in conduit programs

##### 4.2.1. Paragraph 34

The ASF does not support the proposed differential treatment of second loss enhancements between sponsoring banks (based on external ratings) and originating banks (capital deduction). Each enhancement is provided on an individual basis and documented separately. Obligations are clearly disclosed and the underlying risks are the same regardless of whether the enhancement provider is an originator or sponsor.

##### 4.2.2. Paragraph 54

The ASF supports the Basel Committee’s objective to ensure a common approach to liquidity facilities provided to conduits. The ASF supports the need to ensure that liquidity facilities do not provide credit support to investors and therefore should not be available to cover “defaulted” assets. The ASF does not support however, the Basel Committee’s proposed “deteriorated assets” test. For example, liquidity facilities industry wide typically protect investors against an inability to issue commercial paper due to the downgrade of underlying assets but quite rightly do not protect investors against defaulted assets.

##### 4.2.3. Paragraph 55

The ASF does not support a 100% risk weighting for liquidity facilities. As set out in 4.1.3 above, the ASF strongly supports the adoption of a look through approach to liquidity facilities.

#### 4.3. Internal Rating Based (IRB) Approach

##### 4.3.1. Paragraph 59 – The treatment for issuing banks

Once again, the ASF opposes the differing treatment of originating, sponsoring and investing banks. There is no justification for the requirement that originating banks deduct the full amount of retained first loss positions regardless of the IRB capital requirement.

#### 4.4. Specific Issues/Questions for Comment:

##### 4.4.1. What are the industry's views on the best way forward for the development of a more risk-sensitive approach to securitisation in the IRB approach?

Banks are being encouraged to use the IRB approach but the Basel Committee still proposes 'for the sake of conservatism' to apply a 100% LGD to securitisation tranches. However, as per paragraph 64, it will continue to look at alternative approaches.

Banks should be able to apply a transparent assessment of the expected Probabilities of Default (PD's) and LGD's when assessing securitisation exposures. The differential to unsecured rated debt for example, is unwarranted and disadvantageous to securitisation.

The imposition of a 100% LGD for securitisation exposures does not align the capital requirement with the economic risk in many instances. In the case of highly rated senior securities (AAA or AA) applying a 100% LGD under the Foundation IRB approach will produce a higher risk weighting than that achieved under the Standardised model (28% vs 20%) and a risk weighting double that required for non-securitised exposures (corporates at 14%).

The adverse capital treatment is compounded for liquidity facilities provided to securitisation vehicles. These facilities typically rank *pari passu* with AAA rated note holders in the event of a wind up and contain restrictions on their ability to be drawn down. However, banks applying the foundation IRB approach must apply a 75% Exposure At Default (EAD) and a 100% LGD. This results in a capital charge far in excess of the underlying economic risk position ( $75\% \times 28\% \times 8\% = 1.7\%$ ). This is a significantly higher capital charge than that produced by internal economic risk capital allocation models.

The ASF recommends allowing banks to calculate a LGD within its IRB model in the same manner as for non securitised exposures.

##### 4.4.2. With respect to the two-legged or sliding-scale approach, what are the industry's views on possible methods for calibrating numbers for the adjustment factor consistent with less than dollar-for-dollar deduction of first-loss positions?

Where a bank retains a first loss position, the ASF supports the two-legged sliding scale approach. In this case it will involve determining an amount of capital held on balance sheet against the underlying assets and then assessing how much credit risk on the portfolio has been transferred to quantify the capital released. Where a retained first loss position is less than the on balance sheet IRB capital requirement, an amount of capital should be released.

However, the ASF does not support the concept that the total amount of capital allocated to a securitised portfolio should be in excess of the balance sheet requirement. The ASF does not support that the aggregate amount of credit risk on the underlying assets increases as a result of securitisation.

##### 4.4.3. Does the differentiation in treatment on the basis of being an issuer or investor bank provide a balanced and consistent economic approach?

To ensure that securitisation is available as a risk management tool for banks, the ASF recommends the Basel Committee apply a consistent approach across similar risks regardless of whether a bank is acting as originator, sponsor or investor.

The ASF believes any potential concerns relating to structural or moral risk associated with securitisation are addressed adequately through the proposed operational requirements (paragraph 90) and disclosures presently made within securitisation structure

documentation. The ASF does not therefore support any differentiation in the treatment of securitisation exposures between banks acting as originators, investors or sponsors.

The ASF supports the effective operation of APRA's existing guidelines APS 120, requiring individual documentation, transactions to be undertaken on market terms and conditions and disclosure regarding the extent of the facility, to ensure exposures can be treated as arms length.

#### 4.5. The Treatment of explicit risks associated with synthetic securitisation

The ASF is supportive of the Basel Committee's objective to close the opportunity for regulatory arbitrage through the use of synthetic securitisation. It is important however, for the continued development of the market that the post securitisation treatment of such exposures is not unnecessarily conservative, which when combined with the additional costs associated with such transactions could significantly inhibit the development of this market .

The ASF recommends an overall objective to ensure that the risk weighting of an asset portfolio cannot be increased through dividing the risk participation into tranches through synthetic securitisation. Hence, the sum of the capital requirements for each tranche (including any first loss tranche) should be identical to the capital required to support the portfolio on balance sheet.

When allocating the appropriate risk weightings on tranches under the **standardised approach**, the balancing item should be the risk of the last to default piece (ie the super senior tranche) regardless of its external rating. Given that the originating bank typically retains the first loss tranche, the equation should balance out fairly. By way of illustration:-

##### Pre Securitisation

Portfolio Size (\$)	Rating	Risk Weighting On Balance Sheet	Risk Weighted Assets	Capital at 8% (\$)
1,500	A	50%	750	60.0

##### Post Securitisation

Tranche Size (\$)	Rating	Risk Weighting Post Synthetic Securitisation	Risk Weighted Assets	Capital at 8% (\$)
50	Unrated	Capital deduction		50.0
100	Subordinated BBB	100%	100	8.0
100	Senior AAA	20%	20	1.6
1,250	Super Senior AAA	Preferential	Implied	0.4

*Note Super senior cannot have a negative risk weighting.*

In this example, had the originator chosen to retain all AAA rated bonds (1,350) the appropriate capital required is 2.0 (such that the total still equals 60).

Under the **IRB approach**, if a bank chooses to retain a senior piece (because it is satisfied with the risk profile and it would be uneconomic to transfer this to a third party), the bank should simply be able to assign an appropriate PD and LGD to the restructured risk. There should be no arbitrage opportunities since the bank assigned the PD and LGD to the asset portfolio in the first instance – why arbitrage itself!

##### 4.5.1. Paragraph 81 and 82 – Retained/repurchased senior/mezzanine risk

The ASF does not support the Basel Committee's requirement that a bank transfer senior risk if it is comfortable with the exposure. It is generally accepted by ratings agencies that a bank has successfully reduced its credit risk to the extent it is able to sell off debt with a

lower rating than its own. For example, a AA rated bank is improving its overall credit profile by selling off an A rated subordinated tranche.

The ASF recommends that retained first loss positions should attract the same capital requirement as that of a traditional securitisation, calculated utilising a sliding-scale approach capped at the on balance sheet IRB capital requirement. Limiting the size of the first loss tranche to expected loss will prevent transactions where a portion of unexpected loss, but not all, is transferred. These transactions are still of benefit to banks. This argument should also be applied to situations where the bank retains the first loss and super senior exposures.

#### 4.5.2. Paragraph 83 – Retention of both first-loss and senior risk

The ASF is of the view that requiring the sale of a minimum amount of senior risk to gain capital relief on retained super senior risk exposures, may make transactions uneconomic and prevent transactions that have positive risk transferral of the lower levels of risk.

Arbitrage should be prevented as the retained exposures are assessed as part of the IRB model. The ASF is also of the same view where it is proposed a bank retains the first loss and super senior exposures.

#### 4.5.3. Paragraph 85 – Operational Requirements

The ASF requests further clarification on what the Basel Committee proposes to be a “preferential” capital charge.

#### 4.5.4. Paragraph 86 – Structural Criteria

The ASF does not support the requirement that a substantive amount of AAA rated notes be issued or the need for two ratings agencies. The ASF believes both requirements again may create a disincentive to transfer risk via synthetic securitisation.

### 4.6. Implicit and Residual Risks

#### 4.6.1. Paragraph 89

The ASF opposes the introduction of a capital charge for securitisation to address implicit or residual risks such as moral risks.

The ASF believes any potential risks are addressed adequately through the proposed operational requirements (paragraph 90) and disclosures made within securitisation structure documentation. Each facility is provided on an individual basis and documented separately. Obligations are clearly disclosed and the underlying risks are the same regardless of whether the facility provider is an originator, sponsor or investor.

This is evidenced through the effective operation of APRA’s existing guidelines APS 120, requiring individual documentation, transactions to be undertaken on market terms and conditions and disclosure regarding the extent of the facility, to ensure exposures can be treated as arms length.

### 4.7. Disclosure Requirements

#### 4.7.1. Paragraph 93 – Disclosure of liquidity facilities

The ASF does not support the Basel Committee’s proposed disclosure requirements for liquidity facilities in Statutory Accounts. The ASF does not believe there are features of liquidity facilities to CP conduits that warrant more detailed or separate disclosure to liquidity commitments extended by banks to corporate or other entities. In addition, disclosure of such information by deal would require ASF members to disclose confidential competitive information.



## **Appendix A**

ABN AMRO Australia  
Adelaide Bank  
ANZ Bank  
Bank of Queensland  
BankWest  
Bendigo Bank  
Clayton Utz  
Commonwealth Bank  
Corrs Chambers Westgarth  
Credit Suisse First Boston  
Deloitte  
Deutsche Bank  
Freehills  
Gadens Ridgeway  
Homeside  
JP Morgan  
Macquarie Bank  
Mallesons Stephen Jacques  
Members Equity  
Merrill Lynch  
National Australia Bank  
Perpetual  
Salomon Smith Barney  
SG Australia  
St George Bank  
Suncorp Metway  
UBS Warburg  
Westpac