IV. Asset securitisation[1] (paragraphs 516-546)

Preliminary remarks

The Basel Committee's intention to establish uniform, global prudential rules for securitisations helps to create a level playing field in this field and is explicitly welcomed, especially since at present national rules are determined to a large extent by the particularities of national legal regimes (e.g. of accounting rules). To achieve a level playing field at international level, it is therefore necessary to establish prudential rules which set mandatory minimum regulatory requirements for all countries and are independent of individual national legal regimes. We therefore believe that any national discretion allowed should be dropped from the rules.

With regard to capital requirements, it must also be ensured, regardless of the approach chosen (standardised approach or IRB approach), that the overall capital requirements of all banks involved in a securitisation transaction are at least no higher than the capital requirements that would result if the assets were not securitised, as in banking business the credit risk of the underlying asset pool is not affected by the securitisation transaction.

Asset-backed transactions and synthetic securitisations, if used sensibly and structured professionally, can be an important risk-based portfolio management tool and also allow smaller companies to shift or hedge their risks. Not least, they also enable banks to manage risk efficiently. The restrictive treatment of such transactions now being considered by the Basel Committee will seriously impair a functioning market.

A point of criticism is that some of the proposed rules are still incomplete or only outlined in brief. This goes particularly for the treatment of synthetic securitisations and the inclusion of securitisations in the IRB approach. It is therefore essential that work in these areas in particular is continued in close contact with the banking industry even after expiry of the consultation period.

[1] The Association of German Banks wishes to point out that the comments on IV. "Asset Securitisation" are subject to approval by its committees.

1. The treatment of explicit risks associated with securitisations under the standardised approach (paragraphs 518-536)

(i) Treatment for originating banks (paragraphs 518-523)

(a) Minimum operational requirements for achieving a clean break (paragraphs 518-519)

Accounting rules differ from country to country and also pursue a different aim than prudential standards. For this reason, answering the question of whether securitised assets should no longer be recognised for regulatory capital purposes must not depend on whether or not these assets have to be shown in the balance sheet under national rules. In the case of true sale structures, what should matter for prudential purposes is that the securitising bank no longer has any power of disposal over the securitised assets. To this end, minimum regulatory standards that must be applied internationally without regard to national legal regimes should be established.

It should be made clear in this connection that retaining residual risks does not rule out compliance with the criteria for a clean break, as long as suitable treatment of these risks is ensured.

(b) Minimum capital requirements for credit enhancements (paragraphs 520-522)

According to the Basel Committee (paragraph 520), originators and loan servicers that provide credit enhancement must deduct the full amount of the credit enhancement from capital, taking into account the risk-based capital charge that would have been assessed if the assets were held on the balance sheet.

This requirement is not clear. It is made even unclearer by the reference to the capital weights that have to be applied by a bank investing in asset-backed securities (ABS) (paragraph 526). This could mean that banks should (a) deduct the credit enhancement from capital, (b) cover it with capital as if the asset were still held on the balance sheet, or (c) cover it with capital as if they had invested in such an ABS.

In our view, when setting the capital requirements for credit enhancements that have been provided, it should first be borne in mind that only unexpected losses need to be covered with capital for prudential purposes. Expected losses, on the other hand, are normally already covered by banks via risk premiums. If loans and income earned on these (e.g. interest payments) are transferred under securitisation structures to a special-purpose

vehicle (SPV), the originating bank no longer receives any risk premium. In these cases, where credit enhancements by means of first-loss retention or credit guarantees to the SPV up to the amount of the expected loss are involved, a deduction from capital is therefore appropriate. Any losses on the securitised portfolio lead to a reduction in the period profit and thus indirectly to a reduction in the balance sheet capital of the credit-enhancing bank. The amount deducted should therefore be reduced accordingly by the amount of the loss incurred. Full deduction from capital of the credit enhancement is also not justified if income (e.g. via an interest rate swap) is available to the asset seller from the assets sold.

Forms of credit enhancement described above that go beyond first-loss should, on the other hand, be treated like “normal” risk assets in accordance with the arrangements under the modified standardised approach.

Credit enhancements which create reserves at SPV level to cover the expected losses, such as over-collateralisation (the volume of assets transferred to the SPV exceeds the nominal value of the securities issued by the SPV) or purchase price discounts (the purchase price paid by the SPV for the assets is lower than the book value), are included as costs in the profit and loss account, reduce earnings and thus indirectly also the balance sheet capital. There should therefore be no requirement to provide additional capital in these cases.

The Basel Committee also suggests that, subject to national discretion, second-loss credit enhancement may be treated as a direct credit substitute. The condition for this is a significant first-loss protection that must be provided by a third party and may elevate the credit quality of the second-loss enhancement to an investment grade level (BBB- or better). Alternatively, a second-loss enhancement may also be deducted from capital.

This arrangement appears to imply that a second-loss credit enhancement may also generally be deducted from capital. This is inappropriate. As already explained, a deduction from capital is only justified for retained first-loss positions equivalent to the amount of the expected losses. Second-loss credit enhancements that are not designed to cover expected losses should, on the other hand, be treated as normal risk assets in an internationally uniform manner. In this connection, it should not matter who provided the first-loss credit enhancement. The rating of the second-loss position should not matter either, as higher unexpected losses automatically lead to a lower rating and thus to a higher capital charge. However, it is unclear how these tranches are to be covered with capital if the rating cannot be taken as a basis.

The Basel Committee also proposes that the notional amount of the second-loss should be covered with capital. This is not justified either. As with other risk assets in the banking book, the assessment basis for second-loss tranches should be the book value.

The Basel Committee believes that, apart from contractual provisions for providing short-term liquidity, originators or loan servicers should not be allowed to provide cash advances or liquidity facilities to the SPV to cover short-term deficiencies in cash flow. Subject to national discretion, supervisors are to be allowed to permit the servicer (but not the originator) – where contractually provided for – to advance cash to ensure an uninterrupted flow of payments. This is, however, only to be possible if certain conditions are fulfilled.

Liquidity facilities provided by originators to loan servicers are an important refinancing tool for SPVs if disturbances make refinancing in the marketplace impossible. It is essential that the provision of such facilities is also allowed at supervisory level. It should only be prohibited in cases where the provision of liquidity facilities is for the purpose of funding losses on portfolios. Drawing on a credit line after the failure of the SPV should also be prohibited.

It should also be noted that the rules on the provision of liquidity facilities should, from a risk angle, be independent of whether such liquidity facilities are provided by the originator or the servicer or by third parties.

Unused liquidity facilities should be assigned a credit conversion factor of 20% and generally risk-weighted at 100%. We feel that, subject to fulfilment of the above-mentioned conditions, special treatment of liquidity facilities provided to SPVs is unwarranted. It should generally be possible for an SPV to receive a rating that reflects its risk. For this reason, the rules on liquidity facilities in the modified standardised approach should be applied.

(c) Minimum requirements for revolving securitisations with early amortisation features (paragraph 523)

Revolving credit securitisations[2] which provide for an early wind-down of the securitisation programme if the credit quality of the underlying asset pool deteriorates

[2] “Revolving credit” is understood by the Basel Committee to be credit where the customer can himself determine the amount of the credit within certain limits (e.g. credit card facilities, overdrafts, loan commitments, etc.). The securitisations are mainly collateralised loan obligations (CLOs). These should not be confused with the revolving sale of assets.

significantly are to be assigned a minimum conversion factor of 10% on the notional amount of the securitised asset pool, even if the “clean break” criteria are fulfilled.

This proposal must be rejected, as there is no evidence of any special risk. Early amortisation merely means that that no new facilities are included in the securitisation programme. Banks are not, however, required to repurchase existing, already securitised assets. Facilities used after commencement of the wind-down are covered with capital by banks in accordance with the arrangements under the modified standardised approach.

(ii) Treatment for investing banks (paragraphs 524-530)

Capital requirements for banks’ investments in ABS are to be based on the ratings provided by eligible external credit assessment institutions (ECAIs). According to the Basel Committee, securitisation tranches will be risk-weighted as follows :

External Credit Assessment	**AAA to AA-**	**A+ to A-**	**BBB+ to BBB-**	**BB+ to BB-**	**B+ and below or unrated**
Tranches	20 %	50 %	100 %	150 %	Deduction from capital

Special risk weights for ABS must be rejected. The Basel Committee bases calculation of risk weights on issue ratings in the standardised approach too. In our opinion, investments in ABS should be risk-weighted at the same rate as non-securitised assets. This view is backed by rating agency studies (e.g. Fitch Ibca of 8 January 2001), which show that ABS do not generally carry a higher risk of default than normal risk assets. As the rating reflects the risk regardless of the type of asset, there is no justification for higher risk weights. The planned deduction from capital for ABS with a rating of B+ and below must, in particular, be rejected. Risk weights should, moreover, be set regardless of whether the investment is in own or third-party ABS.

The rules for senior ABS which are part of a securitisation structure that is not rated do not take adequate account of diversification effects and credit enhancements. The general deduction from capital of unrated ABS does not appear justified. A weighting of not more than 150% would be appropriate here. Furthermore, implicit ratings should also be recognised. If, alongside an unrated tranche, there exists a second tranche that is subordinate to the unrated tranche, and if this second tranche has an external rating, it should be possible to apply the risk weight of the rated tranche to the unrated tranche.

According to paragraph 529, the unrated senior tranche of an underlying pool of an ABS that qualifies for the look-through approach and that is composed of assets that are assigned to different risk weight categories may be assigned a risk weighting according to the highest risk-weighted asset that is included in the underlying asset pool. We believe that there is no justification for this and suggest a weighted average approach.

(iii) Treatment for sponsoring banks (paragraphs 531-536)

If, in conduit programmes, banks sponsor SPVs that purchase assets from non-banks and place these on the market and if they provide credit enhancements and liquidity facilities for such securitisation, we feel they should be treated in the same way as other providers of credit enhancements and liquidity facilities. There is no justification from a risk angle for different treatment.

2. Securitisation under IRB: A hybrid approach (paragraphs 537-542)

A point of criticism is that the proposals for a securitisation treatment for IRB are still incomplete. It should therefore be ensured that the proposals can be further elaborated in close contact with the banking industry even after expiry of the consultation period.

(i) Issuing banks (paragraphs 539-540)

According to the Basel Committee, banks issuing securitisation tranches would be allowed to deduct from capital the full amount of retained first-loss positions, regardless of the IRB capital requirement that would otherwise be assessed against the underlying pool of securitised assets. As already explained, we do not feel that this is appropriate in every case. We therefore refer to our remarks on the treatment of first-loss positions under the standardised approach (page ....f.)

The Committee is also considering whether issuing banks that retain tranches with an explicit rating from a recognised ECAI could apply an IRB capital requirement tied to that rating which follows the approach for externally rated tranches held by investor banks.

It should be noted that, when calculating the capital requirements for issuing banks, preference should generally be given to the IRB approach. Issuing banks have enough information at their disposal to be able to determine PDs on the basis of their internal rating systems. Accordingly, use of a ratings system recognised by supervisors should be allowed also for determining the capital requirement for retained tranches.

Excursus I:

A paper circulated by the Basel Committee's Joint Securitisation IRB Group on 15 February 2001 contains proposals for a completely different approach for calculating the capital requirements for originating banks. This Working Group goes much further than the Basel Committee in its negative assessment of securitisation. It suggests that the only reason for securitisation is regulatory arbitrage and challenges the view that securitisation is normally motivated by economic considerations, i.e. that it is used for risk transference and portfolio management purposes.

Under the so-called "foundation approach", supervisors are to determine by what percentage the capital requirements for all securitisation tranches are to be allowed to exceed the capital requirements that would result for banks if they applied the IRB approach to the exposures included in securitisation, the "reference capital level" (so-called "add-on") The most subordinated tranches (possibly also parts of tranches) are to be deducted from capital up to the reference capital level. For calculation of the capital requirements for the more senior tranches (or parts of tranches), the Working Group proposes "spreading" the add-on across the other tranches by means of a formula set by supervisors.

The conclusion that can be drawn from these ideas, i.e. prohibitive treatment, is in our opinion likely to make the securitisation of banks' own assets and their placement on the banking market unattractive in general.

We therefore categorically reject these ideas. As already explained in our preliminary remarks, it must be ensured that the overall capital requirements of all banks involved in the securitisation transaction are at least no higher than the capital requirements that would result if the assets were not securitised.

(ii) Investing banks (paragraphs 541-542)

For banks investing in ABS, the Basel Committee proposes to rely primarily on ratings provided by ECAIs. This is inappropriate in our opinion. Should investing banks have enough information at their disposal to determine PDs on the basis of their internal rating systems, they should be able to use rating systems recognised by supervisors to determine their capital requirements as well.

The Basel Committee also proposes to generally apply a 100% LGD to investments in ABS. There is no justification for this, as in the event of bankruptcy ABS creditors are

treated on a par with original asset creditors and, moreover, there is no difference in regard to collateralisation. Like with uncollateralised exposures, a standard 50% LGD should be set under the IRB foundation approach for ABS as well. Under the advanced approach, the LGD could be determined accordingly by banks themselves.

Unrated tranches are viewed as evidence of low credit quality and should be deducted from capital. While we believe this is generally appropriate, implicit ratings should also be recognised under the IRB approach. See in this connection our remarks on page ...

3. Treatment of implicit risks and residual risks arising from securitisations (paragraphs 543-545)

Implicit recourse, i.e. provision of support to a securitisation transaction by a bank that exceeds its contractual obligations, is to be heavily penalised. Due account should be taken in this connection of the principle of proportionality.

Excursus II:

The treatment of explicit risks arising from synthetic securitisations (paragraph 68 ff. of the Supporting Document on Asset Securitisation)

Synthetic securitisations are an important portfolio management tool for banks, particularly in the area of medium to long-term securitisations (so-called “term ABS”). According to Moody’s, 14 of the 15 term ABS in Germany last year were synthetic. At the same time, the volume of such transactions jumped by over 70%. According to Merrill Lynch & Co., the total volume of synthetic securitisations in Europe more than doubled in 2000 to almost $ 40 billion. These transactions are expected to play an even more important role in the future. For this reason, the Basel Committee’s intention to harmonise the prudential treatment of such transactions at global level is expressly welcomed.

Such harmonisation is required particularly also because of the rules in force in the United States. These result in what are in some cases serious competitive disadvantages for German banks, especially where banks act as guarantors in synthetic securitisation transactions. Whereas, for example, US guarantor banks that have an adequate internal risk management system only have to risk-weight a credit default swap linked to a super senior tranche at 20%, regardless of the risk weight assigned to each borrower, German banks are required to risk-weight such instruments at 100%.

What must be criticised, however, is that the proposals for the treatment of synthetic securitisations are still incomplete. It should therefore be ensured that these proposals can be further elaborated in close contact with the banking industry even after expiry of the consultation period.

A. Degree of risk transference

Retention of first-loss

According to the Basel Committee, retained first-loss positions in synthetic transactions are also to be deducted from capital. This is inappropriate. In measurement of the capital charge for first-loss on synthetic securitisations, it should be borne in mind that under the current prudential rules only unexpected losses need to be covered with capital. Expected losses, on the other hand, are covered by the risk premiums accruing. Unlike true sale ABS, assets in synthetic securitisations remain on the balance sheet of the originating institution. For this reason, the exposure risk premiums covering the amount of the expected losses accrue to the bank during the term of the exposures. Provided it is ensured that the originating bank will receive interest income equivalent to the size of the expected losses, it is not necessary to cover the part of the first-loss position containing the expected losses with capital.

Retained portions of the first-loss position that exceed expected loss should, like true sale ABS, be treated for regulatory capital purposes as “normal” risk assets in accordance with the arrangements under the modified standardised approach.

Also under discussion is whether the first-loss position should be limited to expected losses. This must be rejected. First-loss positions that exceed expected losses should be treated as “normal” risk assets in accordance with the arrangements under the modified standardised approach. In this way, the risk incurred by the originating bank would be adequately addressed; restriction of the first-loss position to the amount of expected losses is unacceptable. Such a restriction is, moreover, at odds with market practice. Rating agencies normally expect a first-loss position that at least slightly exceeds expected losses. Banks should be given enough scope in this connection for gearing transactions to capital market and investor requirements.

Retained/repurchased senior/mezzanine risk

The Basel Committee is discussing the principles and the operational requirements which would make it acceptable for the originating bank to retain the senior risk position. We believe that retention of a senior risk position should definitely be possible. The risk of the position is reflected either in the internal rating provided by a rating system recognised by supervisors or, where the standardised approach is concerned, in the rating provided by a recognised rating agency and is covered with capital by banks in accordance with the arrangements under the modified standardised approach. No special requirements are therefore needed.

Retention of both first-loss and senior risk

If the originating bank holds both the first-loss and the senior risk positions, the Basel Committee believes that in an extreme case it could transfer only DM 1 worth of risk to the market and thus reduce its capital requirements significantly while still effectively maintaining the same risk. To avert such a situation, the Basel Committee is considering the following options:

1. Require that the retained first-loss be restricted to expected loss in order for the retained senior risk to qualify for the lower capital requirement ;
2. Require a minimum percentage of the nominal amount of the portfolio to be transferred to the market;
3. Require a minimum transfer of risk to the market, i.e. notes issued to the market must be AAA;
4. Impose a minimum time period for which notes must be in issue prior to repurchase;
5. Do not recognise any implicit rating on retained or repurchased senior positions but apply the capital charges as set out for unrated structures in traditional asset-backed security structures.

It is correct that asset securitisation may enable banks to obtain lower capital requirements than those under the modified standardised approach. However, the capital savings result in this case from the fact the use of external ratings allows a capital charge more strongly geared to the actual risk of the securitised portfolio for non-externally rated assets as well. This is one of the targets explicitly pursued by the Basel Committee in its revision of the Capital Accord and should therefore not be penalised at supervisory level. Branding such an approach from the start as “capital arbitrage” is totally unreasonable. For this reason, all restrictions on the retention of first-loss and senior risk should be dropped.
The requirements proposed above meet with the following reservations:

1. Restriction of the first-loss position to expected loss is unacceptable (see above).
2. The requirement that a minimum percentage of the nominal amount be transferred to the market is unnecessary. Also, due to the diversity of possible transactions (e.g. depending on the structure of the securitised portfolio or investors' preferences), it could not reasonably be determined.
3. The requirement of a minimum transfer of risk to the market is unnecessary and should therefore be dropped. Moreover, the risk transferred to the market is likely to be small particularly in the case of AAA-rated securities.
4. Imposition of a minimum time period for which notes must be in issue prior to repurchase must be rejected. In order to support the market, banks must at least be able to repurchase part of the notes issued to the market.
5. The proposal that unrated senior tranches be treated for regulatory capital purposes like unrated structures in traditional asset-backed security structures must be rejected. Here, too, "implicit ratings" should be recognised (see our remarks on page...

B. Consistency with CRM

The treatment of synthetic securitisations should fit into the overall framework of the New Basel Capital Accord. The rules on capital relief for credit derivatives should therefore – with due regard to our remarks in this connection – also apply to synthetic ABS structures. We wish to draw attention once again in this connection to our rejection of the "w" factor (see page ...). It should also be noted that the proposed "w"-based discrimination of credit derivatives as compared to guarantees is unfair.

C. Operational requirements

The Basel Committee proposes a number of criteria that would have to be met in order to obtain a preferential capital charge for synthetic securitisations. These criteria should, in our opinion, be appropriate for a standardised approach.

Structural criteria

According to the Basel Committee, early amortisation of transactions due to a deterioration in the credit quality of the underlying asset pool should not be possible. This is unreasonable. As already explained in our remarks on the treatment of traditional securitisations with early amortisation clauses (page ...), early amortisation simply means that no new facilities are included in the securitisation programme. Banks are not, however, required to repurchase existing, already securitised assets. Facilities used after

commencement of the wind-down are covered with capital by banks in accordance with the arrangements under the modified standardised approach. This requirement should therefore be dropped.

It is also questionable how issuing a substantive amount of AAA-rated securities to the market strengthens market discipline. This requirement must therefore be rejected.

Securities are also to be rated by at least two rating agencies. If the capital charge is to be based on external ratings, the rating provided by an agency that is recognised by supervisors should suffice. The quality of the rating is, after all, ensured by supervisory recognition. The value of an additional rating is not clear. Non-externally rated transactions (e.g. private placements) should, of course, be possible under the IRB approach.

A further proposal by the Basel Committee is that an SPV, even though highly rated, should not be considered to be an eligible guarantor. This rule is an unwarranted exception to the proposed rules for recognition of guarantees/credit derivatives for regulatory capital purposes under the standardised approach and should therefore be dropped.

According to the Basel Committee, the contract should show which sources of public information would be used to determine the occurrence of a credit event. This must be rejected. For one thing, there are cases where banks are prohibited by banking secrecy rules from making a credit event public. For another, adequate sources of information for determining the occurrence of a credit event are not available for all securitised assets.

In addition, a legal opinion is to be required to ascertain that the synthetic securitisation structure actually works as specified to supervisors. This requirement must also be rejected. A legal opinion is usually issued for each transaction; it should, however, be up to supervisors to ascertain the adequacy of the construction.

Risk management criteria

According to the Basel Committee, banks are to have enough capital to cover unhedged exposures. It is not clear in this connection what the Basel Committee means by “unhedged exposures”. If it means those risk assets that are not included in securitisation transactions, this requirement is definitely fulfilled. As a synthetic ABS transaction does not affect the risk arising from unsecuritised assets, the regulatory capital charge covers the risk arising from unsecuritised assets even after outplacement of other assets. Under

no circumstances should the execution of a securitisation transaction mean that positions which are not included in securitisation attract higher capital charges.