ASSOCIATION BELGE DES BANQUES

BELGISCHE VERENIGING VAN BANKEN

BELGIAN BANKERS' ASSOCIATION

**SECOND WORKING PAPER OF THE BASEL COMMITTEE ON SECURITISATION**

**TECHNICAL OBSERVATIONS OF THE BELGIAN BANKERS' ASSOCIATION (ABB-BVB)**

The Basel Committee and the Belgian supervisory authority have released a new Working Paper (WP) for consultation up to December 20th, 2002 following the first consultation rounds in 2001 (CP2 and first WP). In both cases, the system as described was considered to be difficult to apply. The Belgian Bankers' Association (Association belge des Banques – Belgische Vereniging van Banken, in short ABB-BVB) welcomes this new effort, which however raises a number of serious problems, as the WP is hardly any better than the previous paper.

The general observations in the first section below are described and illustrated more into detail in the following sections (No. B to D). A short conclusion (section E) gives the principal suggestions which can be deduced from this analysis.

## A. GENERAL OBSERVATIONS

### 1. Logic of the system proposed

- The provisions seem to be the result of the application of two methods which create a very complex regulation.

  a) The elements (concepts, rules, data required, etc.) which are meaningful for one type of activity or niche seem to be extended to securitisation as a whole. Consequently, the rules are theoretical for the other kinds of transactions, i.e. inadequate and impossible to apply conveniently.

  b) The criticism, especially from supervisors, concerning specific practices is generalised in a comparable way in spite of the specific features of the various types of securitisation.

- Consequently, the concepts which are put forward, are very imprecise and subject to very different and probably unsteady interpretations by market players and supervisors alike.

- Some concepts are not adequate at all (e.g. total absence of correlation as required is exaggerated, since there are correlations between all of the risks).

- The WP rightly insists upon the growth of the securitisation market. Most often, originating banks use securitisation chiefly as a means to obtain liquidity and capital relief in the conduct of their core business (be it credit cards, mortgages, corporate loans, etc.). This is a prudential strategy in itself. It is therefore crucial that the capital treatment for such transactions be not overly conservative as opposed to the capital treatment of non-securitised exposure, lest securitisation becomes uneconomic.

## 2. Lack of clearness

- In fact, this document still is a first draft. The framework as well as the logic are not clear.

- Many concepts are

  not clear : e.g. the concept of *average quality of the pool*, which in many cases cannot be calculated because there are not enough data, or *general market disruption*, which can have very different meanings ;

  nor defined : e.g. *early amortisation*, which in fact is not put into practice and which cannot be used without precisions concerning not only the stated maturity (which is not meaningful for securitisation types such as RMBS or CMBS) but also the legal or the expected maturity (and there can be several maturities), for which one also takes into account the puts and calls unmentioned in the WP and treated in different ways depending on the country (some countries refrain from doing this), or *receivable pool*, which is subjective, as there is no generally accepted formula in this respect (for example in CDO transactions) ;

  or superficially defined : e.g. *implicit support to a transaction*, defined as being non-contractual.

- The application of some concepts is also unclear : e.g. the concept of *granularity* where the tranches of the transactions are so thin, or *thickness*, which is meaningful only for certain types of transactions such as CDO.

- All this fundamentally weakens a rule, the aim of which is to be very precise.

## 3. Provisions which are rigid, complex and difficult to apply

- The  rule as proposed is intended to be utterly precise. In fact, it would be far too much because they are too general. There would no longer be any flexibility in the assessment of the various specific situations.

- "Securitisation" covers a wide variety of structures. Would it not warrant a more specific approach, e.g. per asset class ?

- One does not take into account the fact that the market adapts its behaviour when the risk of a securitisation transaction has not been calculated conveniently (e.g. when it is not cycleproof).

- The treatment of one and the same transaction can be completely different as far as the originator or the investor is concerned. This is illogical and contrary to the goals of the WP.

- Such differences also affect securitisation as such. For example, why is the capital requirement for an ABS transaction much higher than for a loan granted to a corporate with the same rating whereas the rating agencies point out that their methodologies are adapted to these different cases ? The same comparison can be made for example for the treatment of CDO and ABS on the one hand and of retail transactions or transactions with SMEs on the other hand.

- The standardised approach still needs significant improvement, e.g. the weightings for BB and BBB- rated transactions do not reflect the risks (see further).

- The provisions as for the liquidity facilities call for a very different treatment (see further on part C).

## 4. Data

- The data required frequently are not available, or confidential, or their interpretation is not clear (e.g. defining the stress for the AA or A ratings is a justified concern but the existing model will provide figures depending on the quality and precision of the data supply for the model) or their number is insufficient to form a statistical basis.

- The ratings which are used, are very precise but their application is too broad.

- It would be very difficult to integrate the bank's own data.

## 5. High costs

- Implementing and applying such a control system would be very expensive.

- The capital required also would be much too high.

- The cost of the transactions would increase substantially for the customers and this would have very negative effects on the development of this market.

## 6. Supervision

- Such a system easily could lead to an arbitrary application of Pillar 2. It is conceived in such a way as to be very strict. But as such, it does not prevent all too flexible interpretations which would not be clearly contrary to the provisions. Consequently, the authorities of some countries will be very stringent but, in other countries, e.g. if the situation of the banking industry is deteriorating, progressively altering the supervisory practice would be easy.

- The severity of some sanctions (compulsory publication by the bank of transgressions as from the second transgression) makes such a situation very dangerous for the institutions controlled. If it has to rely on an imprecise concept as an implicit support, it becomes no longer possible for the bank to have a precise idea of the operational (or management) risk it is running.

# B. DETAILED OBSERVATIONS ON SECTION C OF THE WP : IRB TREATMENT

7. Although like-rated corporate and ABS positions bear fundamentally the same risk, the proposals included in this second WP continue to suggest that regulatory capital risk-weightings to hold against ABS positions are up to 3.5 times those indicated for like-rated corporate ones.

   Differences in treatment for like-rated corporate and ABS positions from a risk-weighting perspective are incompatible with the important adjustments made by the rating agencies in their rating analysis methodologies with respect to the underlying asset class. For a given underlying collateral, the proposals would therefore lead to much higher regulatory capital charges in the case of an ABS position in comparison with an unsecured corporate position. More importantly, there is no justification for imposing a deduction from capital on a position that has been rated by external rating agencies.

8. There are concerns about the complexity necessitated by the use of the SFA : the inaccuracies that are generated by the difficulty to assess all the inputs needed and that are masked might not be recognised by banks and by regulators.

9. We support permitting to use the RBA for all rated positions, including those that are rated non-investment grade. Applying the RBA for all positions will avoid significant disruption in investment in new ABS issuance and secondary trading activity. We strongly believe that most banks investors will not use the SFA because they will not have access to the necessary SFA inputs due to client confidentiality and bank secrecy rules. Furthermore, if banks investors are not able to use the RBA for all positions but must rather use the SFA for some of them, they will simply not buy those securities and the market liquidity will be reduced.

10. Calculation of KIRB - Positions up to KIRB must be deducted from capital. In practise, it will not be uncommon that the equity tranche of a corporate CDO will be much lower than KIRB. It means that any tranche above equity (usually rated at least BB) and below KIRB that is kept by the originating bank will have to be deducted too. This could be a major issue for originating banks that cannot distribute the BB tranche due to a lack of market appetite (as is currently the case). Would it not be yet another argument for a more favourable treatment of non-investment grade tranches with an external rating or an implied rating ?

11. Enhancement level, thickness, granularity, relative seniority, LGD - The various factors that must be calculated to adjust the capital treatment of each tranche of interest are precisely the same (combined with many others and severe stress factors) as those used by rating agencies. The external rating and the corresponding default probability are not a measure of expected loss only. Though it cannot be denied that the ratings of the various tranches of securitised transactions have migrated substantially over the last few years, the models used by rating agencies today have been refined to encompass the whole economic cycle. Would it not be possible for the regulators to work with rating agencies in order to be satisfied with the assumptions behind their models, and to align the capital treatment of securitised exposure with this of non-securitised exposure ? As the proposal stands today, the calculation of such factors requires a substantial amount of work for each securitised exposure, while not necessarily bringing the corresponding amount of added-value in terms of risk capital adequacy.

12. Synthetic securitisation : operational criteria (§ 505) - Condition (e) for a synthetic hedge to be recognised for risk-based capital

purposes states that the first loss piece and the cost for the originating bank cannot increase after the transaction's inception. The various credit enhancements given by the originator to investors should definitely be taken into account in the capital treatment (which should be higher with such enhancements rather than without). However, according to this clause, a transaction featuring the above credit enhancements (either plainly or in a more subtle way) would simply be ignored by regulators for capital relief purposes. Would it not be possible to calculate a capital increment for different types of credit enhancements, while maintaining the principle of capital reduction if condition (d) is fulfilled (transfer significant credit risk) ?

**C. DETAILED OBSERVATIONS ON SECTION D OF THE WP : LIQUIDITY**

13. Generally speaking several elements of the methodology applied to liquidity facilities are either somewhat vague, or actually based essentially on a CDO approach, which is not exactly applicable as such to a liquidity facility, for example as part of a trade receivables securitisation programme. More specifically, the following items should be mentioned.

14. § 45 (p. 10) - The definition of the concept of "general market disruption" seems to be too vague. For instance, the WP states that "there is a general market disruption such that third party investors are unwilling to purchase capital market instruments issued by a variety of entities at any price". Although the concept as such is understandable, one could wonder how to interprete a situation where for example investors would be willing to purchase at a price higher than that of drawing the liquidity facility.

15. § 524 (b) (p. 26) - When examining whether the associated credit risk is the equivalent of investment grade or better, what would be the approach towards a trade receivables securitisation structured according to the Standard & Poor's methodology (enabling an A-1+ short term rating, with an implied AA long term rating) ?

16. § 525 - "The highest risk weight assigned to any of the underlying individual credit exposures covered by the facility" is perfectly understandable in a CDO. However, in the case of a highly diversified portfolio of trade receivables comprising for instance 1,000 obligors (the vast majority of whom are unrated) with no single concentration above 2 % of the portfolio, the question is how to apply point 525.

17. § 528 (a) - Whereas one understands that the facility must not be used to provide credit support, cover losses sustained or serve as permanent funding for the securitisation, it seems for rating agencies very difficult to accept that the facility "clearly identify and limit the circumstances under which it may be drawn". A liquidity facility can usually be drawn at any time, but of course with mitigants (such as an asset quality test) which will prevent it from covering deteriorated credit risk exposures.

18. § 528 (e) (p. 27) - The inclusion of a provision for the automatic reduction or termination of the facility if the average quality of the portfolio falls below investment grade seems also rather applicable in a CDO framework, whereas it makes much less sense for a diversified portfolio of trade receivables on mostly unrated obligors.

**D. DETAILED OBSERVATIONS ON SECTION E OF THE WP : AMORTISATION**

19. An early amortisation mechanism in a “revolving transaction” refers here to a “mechanism that, if triggered, allows investors to be paid out prior to the contractual maturity of the securities issued” (§ 51) (p. 11). Further the WP refers to the “revolving nature” of the credit risks (§ 52). In § 540 further on (p. 28), the WP limits this mechanism to “off-balance sheet exposures”, to “revolving credit nature”, etc.

20. The WP apparently sees no problem in an early amortisation mechanism which is eliminating only the revolving character of the transaction if in no way the existing securitised risk comes back to the originator (§ 52). The same remark goes for § 540. In § 542 the WP also excludes transactions where the early amortisation mimics the maturities of the underlying pool.

21. In the next § 53 (and in § 557), the WP proposes a set of conversion factors for these transactions with early amortisation. These conversion factors seem to be totally focussed on one specific situation, that of credit card receivables causing an excess spread in these transactions (§ 545-556). This seems to be very complex and stringent. For securitisation of uncommitted retail credit lines, these conversion factors are tied to the excess spread lever for securitisations of uncommitted retail credit lines showing these features (for practical details see § 54-58). These rules for credit card receivables seem very rigid and most of all leave little room for alternatives. It seems not too attractive that these rules try to regulate a specific ABS market through new Basel rules. As such it probably limits the market flexibility in an unneeded way.

22. For other types of transactions that do not fall under the exception mentioned, the WP proposes a probably very conservative fixed credit conversion factor, normally 100 %, maybe 80 % and the WP asks feedback for alternative proposals (§ 59-61). This general rule of a FCC (fixed conversion factor) seems to exclude all types of early amortisation outside the specific case of credit card receivables (see also no. 23). It should be more open and negotiable on the basis of the real risk that comes back in every individual case to the originator. Apparently, there is no advantage at all in such a general sanction or regulation. Whereas the presumption in the WP is absolute, there should be room for a rebuttable presumption, based on facts, when one is dealing with clearly accepted exceptions. This absolue would mean that the real economic underlying data are no longer important. This would not be exactly in line with the nature of the IRB approach.

23. In the general terminology (Annex 3. B. 3. General terminology (iii), no. 497, p. 20), the concept of early amortisation is vaguely defined. The WP only defines the difference between controlled and uncontrolled early amortisation. The conditions for having a controlled early amortisation are :

    (a) capital/liquidity plan of the bank in case of early amortisation,
    (b) pro rata sharing of interest, principal, expenses, losses and recoveries based on the beginning of the month balance of receivables outstanding,
    (c) the period for amortisation must be sufficient for 90 % of debt to mature or be recognized in default,
    (d) the amortisation period can be no faster than in normal amortisation.

In respect to this vague definition it should be stressed that the concept of early amortisation could also include all types of contractual clauses which may change the maturity (including all types of credit events, put and call dates inclusing tax clauses, etc.). The Accord should confirm that the proposed regulation is limited to the "early amortisation" in the securitisation of revolving credits stricto sensu.

In that case, the sanctions will be limited to those securitisations that have as a consequence that existing drawings on the revolving committed lines are repaid within the outstanding transactions while at the same time the bank itself becomes exposed to the new drawings under the remaining committed lines or committed open accounts when these new drawings are not really protected.

## E. GENERAL CONCLUSIONS

The lack of clarity of the provisions as proposed and the severe potential sanctions would cause a large scale withdrawal from this activity and a collapse of this market in spite of the current very high amounts and activity in this market and its necessity, especially for risk management.

Consequently, the ABB-BVB suggests

- devising a more readily understandable introduction presenting the overall scheme and enabling an easier reading of the WP,
- splitting up the rules into a limited number of general principles for securitisation as such,
- applying them by means of specific rules to the different types of securitisation,
- taking into account this fundamental distinction when defining precisely all of the concepts,
- aligning the capital treatment of securitised exposure to this of non-securitised exposure when an external rating exists (or an implied rating given by a model validated by rating agencies).