MARQ Services* Submission to Basel Committee on Banking Supervision - Revisions to the Basel Securitisation Framework

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❖ MARQ Services is the business of MARQ Services Management Pty Ltd ("MSM") Australian Financial Services Licence number 422492 and is managed by Morgij Analytics.

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1 Summary

MSM (www.MARQServices.com) is an Australian service provider to the global finance industry specialising in providing the infrastructure for reliable loan level data, standardised reporting and user calibrated analytics for pools of loans including RMBS, covered bonds and balance sheet assets. Morgij Analytics (www.morgij.com.au) is the manager of MSM and a developer and manager of loan reporting and risk management products.

The following is MSM's submission to the BCBC's Consultative Document "Revisions to the Basel Securitisation Framework" dated December 2012.

1.1 Independent Service Provider

As an independent service provider to the global securitisation industry with responsibilities to the buy and sell side as well as regulators, MSM has taken a solution based approach to this submission to the BCBS on this Consultative Document.

1.2 Recommendations

MSM recommendations are contained in each of the sections of this submission. The recommendations are aimed at addressing potential pitfalls around the two alternatives proposed by the BCBS with a specific focus on the entrenchment of Credit Ratings and the question of Maturity.

2 Credit ratings and Credit Rating Agencies

2.1 Approach to ratings within the proposed alternatives

MSM agrees with the Committees concerns relating to mechanic reliance on external ratings and supports efforts to reduce this reliance. While acknowledging that external ratings serve a legitimate and useful function in the regulatory system and the capital markets generally MSM has some concerns about the details of the proposed revisions to the Ratings-Based Approach.

Looking at the two approaches "Alternative A" is, on the face of it, preferable insofar as it explicitly rejects the need for external credit ratings and offers less chance for inter-jurisdictional gaming.

However "Alternative B" seems to the do the exact opposite insofar as it puts the Credit Ratings Agencies or at least the ratings and the language around traditional ratings at the heart of the structure and uses ratings to help determine what securities are "invulnerable to foreseeable events"

The given rating scale in the discussion document is specific to a traditional CRA model used by incumbent major CRAs and does not allow for alternative rating approaches. A CRA could alternatively express ratings through such other measures such as:

- An absolute numerical value of probability of default;
- An absolute numerical value of expected loss;
- An ordinal numerical value of probability of default;
- An ordinal numerical value of expected loss;
- An alphabetic labelling scale different from, and differently calibrated from, the given rating scale.

As an example, MSM has developed a risk measurement scale from 0 to 1500 which can operate as an ordinal numerical value of expected loss.

MSM believes that the development of alternative rating approaches with alternative rating scales would be greatly beneficial to the market, providing market participants, including prudential regulators, with additional perspectives and greater insight on risk, and generating competition between rating agencies.

The effect of specifying a traditional rating scale in regulations would be to privilege the traditional CRAs over alternative approaches, encouraging continued over-reliance on them.

We contend that that in doing this the Committee is doing the exact opposite of what it's stated am of reducing the reliance on the credit agencies by entrenching their methodology into the process while explicitly noting that the committee as concerns about idiosyncratic risks around individual ratings frameworks.

Indeed in recognizing the potential flaws of only one rating at an individual level but then allowing that this idiosyncratic risk is cured by taking the lowest of two or more ratings (as with question 5 of the document) seems at odds with the underlying precepts surrounding this Discussion document. .

Specifically, as noted above the parameters for use in the revised Ratings-Based Approach are expressed to be determined by reference to an external alphabetic rating scale ranging from AAA, AA+ through to CCC-. We have the following concerns.

2.2 Assumption of the Equivalence of Ratings from Different CRAs

The given rating scale assumes that all ratings of a given designation represent an equivalent level of risk, regardless of which CRA has provided the rating. Also, the proposed changes do not provide any guidance as to what each rating on the scale means, implicitly outsourcing this decision to each CRA.

In fact, different CRAs, even while using substantially the same rating scale, adopt substantially different approaches to developing ratings. Specifically:

- Different CRAs have different definitions of what the same rating label means;
- Different CRAs have different methodologies for producing ratings, as set out in their ratings criteria;
- Different CRAs use ratings to indicate different underlying measures of risk. For example, some CRAs use ratings to primarily express an opinion of probability of default, while some CRAs use ratings to primarily express an opinion of expected loss.

As a result, two different CRAs may apply the same rating of AA+ (say) to a security, but be using this to represent very different opinions about the risk of the security.

MSM believes that a regulatory approach which assumes that the ratings of different CRAs are equivalent is highly problematic. Specifically:

- It encourages arbitrage or 'rating shopping' where entities will seek out the CRA whose approach results in the highest rating for any given security;
- It encourages market participants to base decisions on ratings labels alone, rather than incorporating their understanding of the different methodologies and meanings of ratings from different CRAs; and
- It discourages CRAs from developing innovative ratings approaches which might result in ratings that do not naturally fit the given scale.

2.3 Potential to outsource regulation

The given rating scale does not contain any guidance from the Committee on what the different ratings represent as levels of risk. This implicitly 'outsources' the decision about the meaning of ratings to CRAs.

MSM believes that this runs the risk of inappropriate developments in the Ratings-Base Approach over time. Absent any regulatory guidance on the meanings of rating levels, CRAs who change their ratings approach (as happens from time to time) are implicitly changing the prudential regime. Where a security has a rating change for this reason, it will become subject to a different capital treatment despite no actual change in risk.

2.4 Credit rating Cliff effects

Credit ratings are, by their very nature meant to be stable. Stability is designed into the process and desired by both issuers and investors. However this stability means that Credit Ratings are non-dynamic and take some time reacting to changes in underlying credit quality in an iterative manner and thus only react at tipping points.

Accordingly across all ratings gradients Credit Ratings are by their very design prone to cliff effects because of this inability in their design to react to changes except in leaps.

MSM contends that this is counter to what the BCBS is seeking in releasing this discussion document and its plans for a change in the assessment of risk with regard to securitization structures.

2.5 MSM's observations with regard to use of credit ratings within the proposed Alternatives

MSM has the following suggestions to help ensure the good operation of the revised Ratings-Base Approach.

1. The Committee could, instead of using the given scale, develop its own scale (RBA Scale) for the purpose of implementing the revised Ratings-Based Approach. The RBA Scale should avoid using nomenclature already used in any existing CRA approach;
2. This RBA Scale could specify, in some meaningful form, the level of risk represented by each rating level. This could be done using plain language descriptions, probability of default ranges, expected loss ranges, or some other method, or a combination of methods. If desired for continuity, these descriptions could initially be harmonised with existing CRA approached;
3. CRAs could be required to provide the relevant regulator with a map from its own rating scale to the RBA Scale, enabling the use of its ratings in the Ratings-Based Approach.

MSM believes that adoption of these suggestions would reduce reliance on CRAs, encourage innovation and competition in ratings approaches and ensure that control of the prudential system was retained by regulators.

3 Use of Maturity with the revised framework.

3.1 Appropriate to include maturity

MSM believes that it is appropriate that the Committee seeks to include maturity in the analysis framework in order that it better capture changes in the capital value and thus market to market losses or gains on tranches throughout the securitization structure.

Equally by factoring in the maturity as part of the overall framework the BCBS is recognizing that as time increases so the probability of a default increases all other things equal.

This of course supports the proposition that the risk weight floor could or should be higher for longer term maturities than for shorter term ones.

3.2 Maturity Definition

Definitionally however under the revised Framework proposed MSM believes that "maturity" appears to default to the final legal maturity given the requirement that,

> *"The contractual payments must be unconditional and must not be dependant from the actual performance of the securitized assets"*

MSM understands this in the context of liquidity facilities as articulated in the Consultative document that this is appropriate and understands this in context of fixed maturity credit protection instruments but for standard securitisations where the contractual payments rely on the performance of the pool of securitized assets and any defaults that flow from same then this definition seems to need rewording as it seems incongruous to seek to separate payments from

Equally important Importantly though while Maturity seems important from a mark to market basis for stock held in a trading book if a Bank is using the SSFA to generate a capital requirement and if the SSFA expressly requires a "delinquency" component in the capital calculation then to include maturity as well might be to double count any deterioration or improvement in the underlying collateral.