BANK · VERSICHERUNG

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2nd Consultative Document on "Revisions to the securitisation framework"

The Division Bank and Insurance of the Austrian Federal Economic Chamber, as representative of the entire Austrian banking industry, appreciates the possibility to comment on the 2nd Consultative Document on "Revision to the securitisation framework" and would like to submit the following position:

Introduction

The current public and political perception of the asset class, which the proposed risk weight increase further reinforces, still hinders the continued structured finance investment strategy of many banks, given the extremely strong performance of market sectors to which future investment could be restricted due to the proposed revised framework.

In our view, this consultative document is a bit less restrictive than the first document that was published in late 2012. However, it still discriminates asset classes that have performed very well and did not pose any problems over the last fifteen years.

We note with regret that the 2nd consultative document contains the same generalisations across the whole concept of securitisation rather than taking a measured and more reasonable approach based on observed performance. Unfortunately, the paper still makes no distinction between different asset classes and instead adopts a broad one-size-fits-all treatment of all securitisation products. We consider this as a severe conceptual shortcoming. Our view is backed by the empirical evidence of a wide divergence in performance of different securitised asset classes. As already documented in our response to the first proposal on the revised securitisation framework (dated 15 March 2013), practically all European cash securitisation sub-sectors with the exception of CMBS transactions have performed very strongly throughout the financial crisis. In our view, the extremely high mark to market volatility of structured finance securities during the crisis was caused by highly levered structured finance investors turned into forced sellers such as SIVs and CDOs of ABS.

The lack of differentiation between asset classes is considered to be a conceptual problem and the most determining shortcoming identified in the paper. This especially becomes evident in the calibration of the risk weight floor and in the External Ratings Based Approach (for details please refer to our specific comments below).

Another key aspect we do not agree with is the **definition of tranche maturity**. Disregarding prepayments is unrealistic and also overly cautious in our view, and it will exacerbate the impact of the higher risk weights for longer maturity assets.

To sum up, while a simplified hierarchy is deemed positive, even the revised risk weighting proposals would make any new investments unprofitable for a bank. The regime as outlined in the paper could lead to the disappearance of securitisation altogether. **We see the danger of promoting a shift of regulated banking activity into the shadow banking sector.**

In addition, we would welcome if the Basel Committee could provide stakeholders and other market participants with a timetable. This would help remove uncertainty from the market.

Specific Comments

Section 1 – Part 1: Transparency and Comparability

One of the overarching goals of the framework revision is the creation of a level playing field by increasing **transparency and comparability**. Ideally, holders of the same assets should attribute the same risk weight to this exposure. Unless risk weights are publicly prescribed for each publicly offered asset, this ideal is hard to achieve. If calibrated realistically by taking into account the differences of asset classes, the securitisation framework could contribute to a level playing field. However, the IRB approach as proposed in this paper runs the risk of different computations on the same asset.

Section 1 – Part 2: Shortcomings in the current securitisation framework and objectives and principles of the revisions

We believe that the assumptions on which the shortcomings are based do not have enough evidence or are not correct. This applies regarding the following items:

(a) Mechanistic reliance on external ratings: We do not agree with the opinion that “undue mechanistic reliance” is placed on external ratings. Credit rating agencies have already revised their rating models and have taken maturity and tranche thickness into account. Furthermore, given that the vast majority of bank investors will not possess internal rating models for the underlying securitisation assets, the more likely result is that the external ratings based approach will prevail and reliance on external rating agency ratings will remain.

(b) Too low risk weights for highly-rated securitisation exposures, too high risk weights for low-rated senior securitisation exposures: It is not correct that risk weights for capital requirements for highly-rated securitisation exposures proved to be too low. While certain sectors of the market performed very poorly, as stated in our response to the first consultation paper, other sectors performed very strongly, e.g. UK Prime RMBS. This was even

acknowledged by the IMF, in their Working Paper “Securitization: Lessons Learned and the Road Ahead”.[1]

The current consultative document clearly does not differentiate between different asset classes and we believe strongly that this generalisation is inappropriate and is not supported by any evidence. As the IMF Working paper states, the underlying assets within securitisations did typically not behave worse than unsecured assets of comparable credit quality. Sometimes they even performed better. In other words, rather the quality of the underlying assets is pivotal and therefore the driver for performance than whether the assets are securitised or not.

Moreover, the reason why risk weights for all highly rated exposures need to be increased is not explained in this paper. It has also not been explained in the previous consultative document. We therefore fear, that the logic to increase risk weights across the board based on empirical evidence (empirical evidence that seems to contradict the stated IMF studies) will result in significant unwanted effects.

Regarding mezzanine tranches, we understand that it is the intention of the Basel Committee to reduce those risk weights that are too high for senior low rated tranches, but for high rated non-senior tranches the risk weights are rather harsh and lead to a major cliff effect particularly from the senior to the first non-senior tranche directly below the senior tranche.

The Committee explained the calibration and modeling changes that resulted in lower capital requirements for the consultative document 2 compared to the first one. One area was the recognition of 80% of future margin income. However, the excess spread is only recognised for senior tranches although in a securitisation the excess spread is available for all tranches, thus not limited to senior tranches and it is a very important credit enhancement factor for non-senior tranches. To be consistent, the Basel Committee should therefore **recognize the excess spread for non-senior tranches.**

Moreover, rating agencies already take the seniority into account in their models and in the resulting ratings. The Basel Committee overrules the model results with the separation in senior and non-senior tranches and implicitly assumes better performance of senior tranches compared to non-senior tranches from other transactions with the same rating. For example, a CCC senior Greek RMBS would receive a 530% RW (and possibly lower when applying the risk-weight cap for senior securitization exposures) compared to a 5 years UK RMBS CCC non-senior 5% tranche with a risk weight of 1,187.5%! For BB to B rated tranches the difference between senior and non-senior tranches is even roughly three times as high.

Accordingly, we strongly propose to eliminate the differentiation between senior and non-senior tranches especially for retail ABS.

As for maturity and thickness the Basel Committee uses external ratings as the basis for risk weights calculation. It however alters the model results with double counting and

[1]“As the widely varying performance of securitized assets before, during, and after the GFC demonstrates, it would be misleading to discuss the market for securitization as a single, homogenous asset class. For instance, the institutional characteristics of the U.S. subprime mortgage market constitute quite a separate case of securitization from which it is difficult to infer general conclusions about other segments of the securitization market”. IMF Working Paper WP/13/255, November 2013.

differentiation between senior and non-senior tranches which is already accounted for in the rating agencies' models.

Due to the reduced attractiveness, investing banks could, if at all, focus on senior tranches only. This would make the issuance of new transactions more difficult and unattractive for originators from a funding and RWA relief perspective. It could moreover cause unintended negative effects to the European real economy and the housing market.

(c) Cliff effects in capital requirements: The Basel Committee is aiming at reducing cliff effects by the introduction of proposed new risk weights. However, in our view, the introduction of these proposed new RWs will itself introduce a new cliff effect. Holders of legacy asset backed securities will find the risk weight of their portfolio increase by orders of magnitude, even where those portfolios may have already suffered from such a cliff effect by virtue of downgrades in light of tightened rating agency rationale, and in many cases notwithstanding strong performance.

By way of example, an asset originally rated "A" that has been downgraded to "BBB" due to changes in rating agency rationale, though where the underlying assets continue to perform strongly, would now see its risk weight increased from the original 20% to 320%. One potential upshot would be forced selling of otherwise creditworthy bonds, which would lead to otherwise avoidable losses for banks and the erosion of their capital base. We doubt that this is an intended consequence.

(d) Prudence: It is unclear whether the Basel Committee refers to commingling reserves, back up servicers, or call dates when it states that securitisations had a wide range of structural features that did not exist for banks holding the underlying pool outright and that are impossible to capture in models. In our view, features such as interest rate swaps increase default risk only in a limited manner at worst while <u>reducing</u> market risk and cashflow mismatches. Swaps for example are generally structured in a way to minimise default risk by requiring collateral or swap counterparty replacement.

Therefore, we kindly ask the Basel Committee for clarification on what kind of features it refers to and to what extent these will have an impact on risk.

We also strongly disagree with the rejection of the capital neutrality premise; while this may be reasonable for isolated cases, we believe that for the majority of asset classes and transaction types this is even punitive. For the ERB approach at least, the supposed "layering" is already been taken into account into the rating.

(e) Broad consistency with the underlying framework: The Basel Committee aims at consistency of capital charges for a securitisation with capital charges for the underlying pool, in particular for senior tranches. This appears to neglect that senior tranches benefit from credit enhancement features, and that the LGD for the senior tranche of a securitised transaction will be lower than the LGD for the entire portfolio. We do not agree with this principle with regard to the senior tranches of a securitisation.

Sections 2 and 3: Hierarchy of the approaches, proposed approaches

Generally, we agree with the reduction and simplification of hierarchies of approaches. We are also in favour of a reduction of differences to US-Basel III standards. However, the

application of the IRB or ERB approaches will be hindered due to **information constraints** to both institutions and regulators, diluting the Basel Committee's objective of comparability.

(a) Internal Ratings Based Approach: As for the IRB approach, we regard it difficult for regulators to assess how, and against which benchmarks, the approach can reflect the risk of the transactions due to, for example, the transaction's structural features. We fear that some supervisors will deny the use of the IRB approach at all due to information constraints.

The lack of information will probably also have detrimental effects on the treatment of derivative contracts. The paper states on page 7 that *"[w]hen calculating KIRB under the proposed standards, the positive value of a currency or interest rate swap (from the perspective of the SPE) would be included in the numerator (IRB capital charge including EL), but the denominator would not be affected by this exposure. However, the proposed standards do not require banks to incorporate an add-on, such as potential future exposure, when calculating the numerator of KIRB."*

This would imply a requirement for the publication of swap MtM which is not a standard at the moment. It was unclear if the institution would be permitted to calculate this figure as an alternative (introducing further potential inconsistency between different institutions). As a result investing banks could be forced to apply the more punitive ratings approach.

(b) External Ratings Based Approach

As to the External Ratings Based Approach, we would like to repeat that increases in capital requirements and the introduction of additional risk drivers are not justified.

We disagree completely with the position that ratings do not fully reflect the effects of tranche thickness and maturity in a capital adequacy context. Especially in the case of Moody's ratings, the tranche thickness is absolutely taken into consideration. Furthermore, as all agencies' ratings are ratings to the maturity of the exposure, maturity is also taken into consideration.

Furthermore, we believe that the Committee's position on the credit rating agencies taking granularity into account is a misrepresentation and oversimplification.

According to the proposed text, loss and cash-flow analysis as well as sensitivity of ratings to changes in the underlying ratings assumptions should be publicly available. This might lead to a need to subscribe to more agencies or to agencies providing this information. We doubt that all this information is freely available at the moment. We also doubt that this requirement corresponds with the stated intention to reduce reliance on the rating agencies.

The reduction of required ratings to one is generally very welcomed.

Section 4: Changes to the calibration

We welcome the general reduction in capital charges in comparison to the original proposal. Nonetheless, some issues need to be questioned:

The assumption made in the revised model that all loan defaults occur at the maturity (M) of the securitisation, rather than at year one does not seem to be realistic. From the conceptual

point of view it simplifies the modeling, but this assumption is made while at the same time a correlation factor is introduced making the modeling more complex.

Regarding the calibration of the ERB approach, the Committee's position on maturity and tranche thickness adjustments, we refer to our critical comments already made during the first consultation and in this paper above. The second consultative paper generalises as much as the first document, thereby disregarding the overall historical performance of large sectors of the market by introducing risk weights which bear no relation to observed performance.

Regarding Graph 4 (see also table 2 on page 34) no apparent logical explanation is given within the document for the almost four fold increase in risk weights for the best rated assets, which goes completely against the weight of evidence for the best quality transactions (e.g. UK Prime RMBS). This also appears to disregard the tighter CRA credit enhancement requirements for such a transaction to attain an AAA rating (approximately double). In effect, the best quality transactions are being doubly penalised for a long and unblemished track record as a result of the much worse performance of unconnected asset classes such as US Subprime and CDOs of ABS. The document treats all securitised deals on a broad brush approach which is not correct.

Section 5: Other proposed revisions and clarifications

(a) Definition of Tranche Maturity: Unfortunately, the Committee has decided to retain its definition of tranche maturity. We do not agree with the proposed definition.

Ignoring any expected prepayments when calculating maturity is in our view overly cautious and exacerbates the impact of the higher risk weights for longer maturity assets. It merely compounds the error. While we can see that there is a rationale in a prudent regulatory context to cap any assumed CPR rates, to reduce assumed CPR to zero is unrealistic and cannot be proven by any empirical evidence for most asset classes. The effect of disregarding prepayments will be that in practice, almost all securitisation exposures will get higher risk weights than the figure proposed for one year exposures.

It has to be assumed that for the majority of the transactions, the maximum of a 5 years maturity has to be used for the calculation of the risk weights. This is because the unconditional contractual cash flows are used for the maturity calculation, without taking into account prepayments and defaults. This is also because legal maturities are normally longer than 5 years. The maturity is however already taken into account by the external rating. Longer legal maturities result in higher loss rates and thus higher required credit enhancement in rating agency's models. Still, the Committee uses the maturity and its definition to increase the risk weight with a kind of double counting. In contrast to other asset classes a time horizon over one year is used.

(b) Risk weight floor of 15%: The decrease of risk weight floor from 20% to 15% is deemed positive, but it is still more than twice as high as the 7% risk weight of the current framework. In order to qualify for this, a transaction must have a maturity of one year or less and thus in practice the floor will be closer to 25% in the vast majority of cases. The calculating method for the maturity ignores any kind of prepayment and relies solely on contractual cash flows. As such, in practice very few investments will qualify for a weighting of 15% under these proposals. Furthermore, even the proposed floor of 15% still appears far too high for those asset classes which can demonstrate very good track records.

One aim is to reduce the variation in outcomes for similar risks. We would be pleased to have a clarification as to how this can be compared to other AAA rated assets such as sovereign bonds or covered bonds.

(c) Maximum capital requirement (overall cap): We agree with the Basel Committee's view that the maximum capital requirement for securitisation tranches is capped with the IRB capital requirement of the underlying exposures if they had not been securitised. We very much welcome the application for all three approaches.

We ask you to take our remarks into consideration.

Yours sincerely,

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