



Chris Dalton, Chief Executive Officer
Australian Securitisation Forum
3 Spring Street
SYDNEY NSW 2000

+61-2-8243-3900

cdalton@securitisation.com.au

21 March 2014

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

RESPONSE TO REVISIONS TO BCBS SECURITISATION FRAMEWORK – CONSULTATIVE DOCUMENT

The Australian Securitisation Forum ("AuSF") is grateful for the opportunity to provide the following responses to the Consultative Document.

The AuSF was formed in 1989 to promote the development of securitisation in Australia. As the peak industry body representing the securitisation market, the ASF performs a pivotal awareness and training role for government, regulators, the public, investors and others who have an interest or potential interest both in Australia and overseas, regarding the benefits of securitisation in Australia and aspects of the Australian securitisation industry.

This submission is made by the ASF's Regulatory & Prudential sub-committee, comprising a cross-section of securitisation market representatives (banks, non-banks and an investor, a lenders' mortgage insurer, an investment bank and a law firm). It has also received input and support from the Australian Bankers' Association.

Please do not hesitate to contact me should you wish to discuss these matters further.

A handwritten signature in black ink that reads "Chris Dalton". The signature is written in a cursive, flowing style.

CHRIS DALTON
Chief Executive Officer

1. Summary

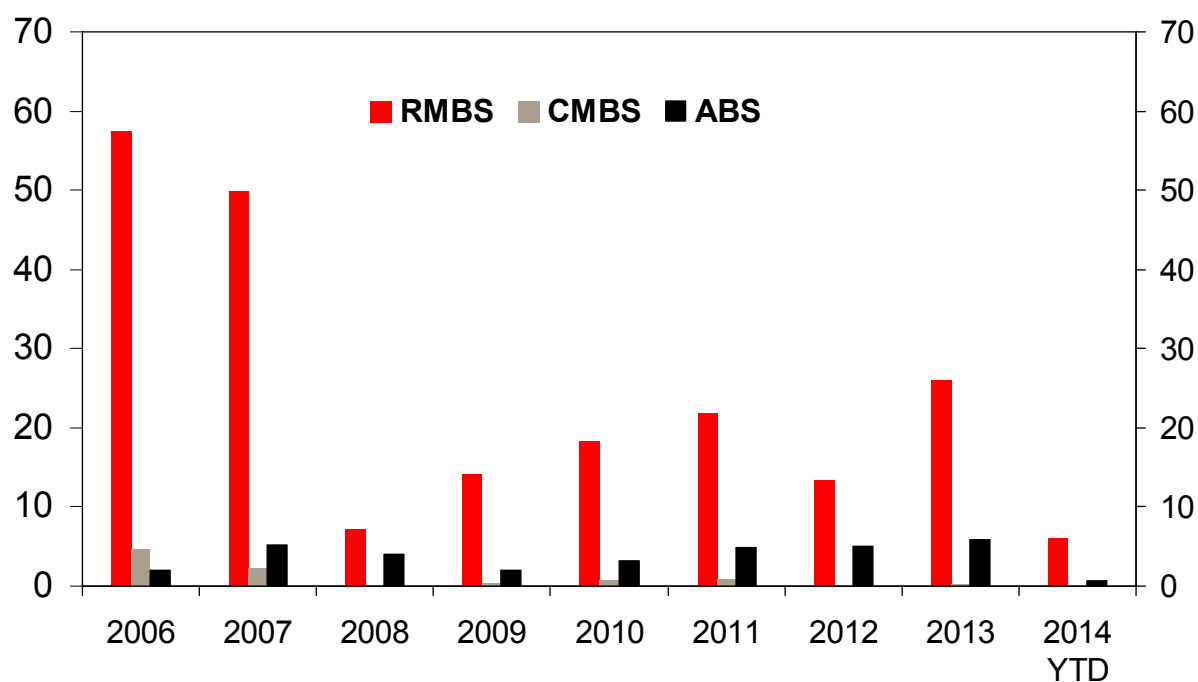
The Australian Securitisation Forum (“AuSF”) welcomes the fact that the Basel Committee (the “Committee”) has taken on a number of comments from the AuSF and others, particularly in relation to risk weights and risk weight floors being lowered; simpler calculations; and, assumptions brought into line with existing IRB framework. However, the draft securitisation framework will increase the cost of securitisations because investors will demand higher returns to compensate for the increased cost of carrying such securities on balance sheet. Inevitably, this will feedback in to increased issuer borrowing costs. This usually leads to more expensive loans for those in the real economy and reduces competition by reducing contestability in retail lending markets due to the greater reliance lower-rated institutions place on market-based/off-balance sheet funding compared to their larger brethren.

Indeed, for Australian financial institutions securitisation is a vital funding tool. In part, this is evidenced by the Australian RMBS market being the largest non-agency/non-GSE RMBS in the world last year. In 2013, Australian issuers issued A\$26bn (US\$23.4bn) of RMBS. Importantly, ~75% of investors (by value) in Australian securitisations are banks. Increasing the amount of capital that banks have to hold against securitisation exposures will increase the margin that these banks will have to earn on securitisation exposures to maintain their return on capital. As a result, the framework is likely to place a constraint on the market at the same time as a number of other regulators and international bodies have recognised the value of securitisation as a funding tool that can contribute to economic growth and restart lending markets¹. The cost of credit to consumers will increase; as the prices banks are able to offer consumers will be impact by the increased cost of securitisation deals. In the worst case, banks will invest less in securitisations, and the amount of available credit in the economy would reduce and liquidity in the product will inevitably worsen, too.

The importance of securitisation market for banks in Australia is amplified because the small stock of Australian government securities means Australian banks are required instead to hold other securities to meet their LCR requirement such as through a central bank facility in which RMBS and ABS can be pledged for cash liquidity. Increasing the capital that banks have to hold against these assets will impact the profitability of the banking industry, again likely to lead to an increased cost of borrowing for the consumer.

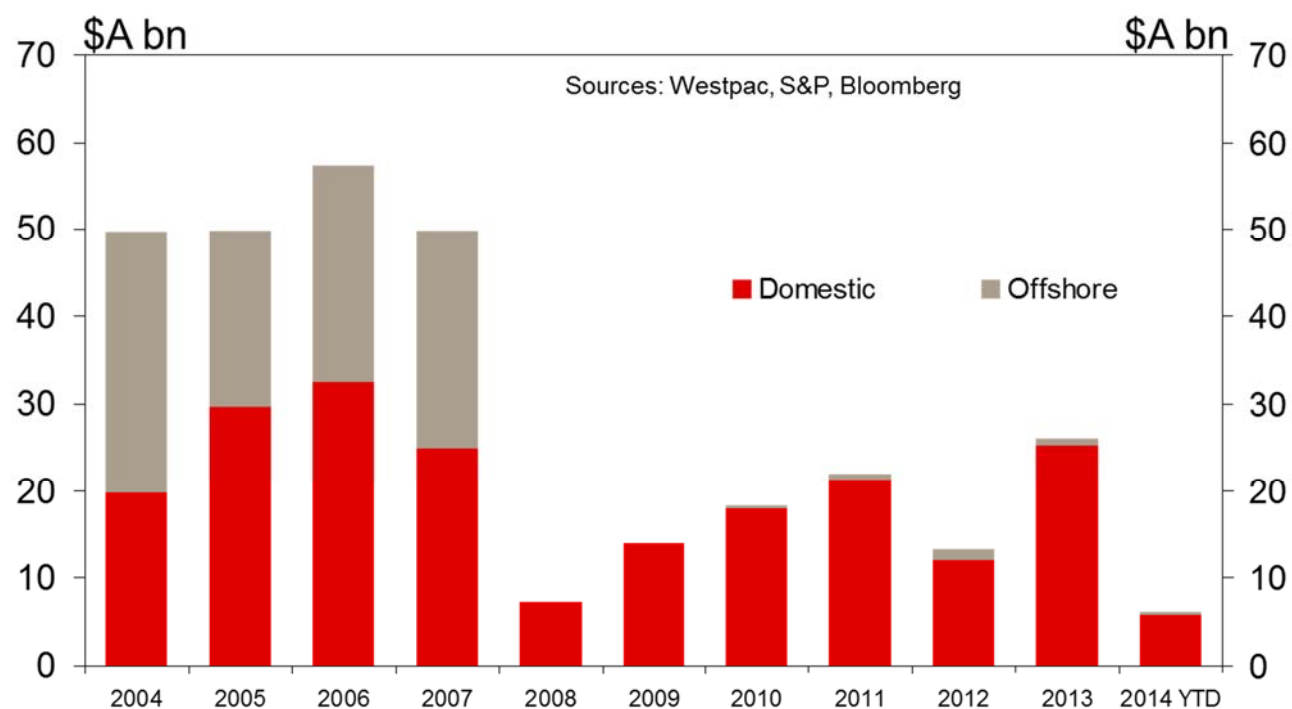
¹ “...., solving the issue of funding for Australia’s future and, more generally, of driving future global economic growth is an important issue. We see the recovery of sustainable securitisation markets as an important part of a wider solution.” Australian securitisation 2013, a speech by Greg Tanzer, Commissioner, Australian Securities and Investment Commission

Total Securitisation Issuance 2006 – 2014



Source: Westpac Institutional Bank

RMBS Issuance 2004-2014



2. Objectives and principles of the revisions

The AuSF notes that the Committee have set out a number of objectives and principles that have guided the drafting of the framework document. The AuSF does not intend to comment on each objective and principle, but does make the following high level observations:

1. The AuSF recognises that the Committee have taken steps to simplify the securitisation framework in this consultation document. However, the IRB approach is still complex and could be simplified.
2. The AuSF understands that the Committee is concerned that the process of securitisation can add a degree of complexity and “model risk” which would justify a rejection of a strict “capital neutrality” premise. However the AuSF believe that a number of initiatives that have been implemented with respect to securitisation should help to mitigate these concerns and allow for capital neutrality to hold. The “skin-in-the game” requirements imposed by regulators now mean that originator and investor interests are much more aligned. In addition, due diligence and loan level data requirements that have been imposed mean that investors have far more information at their disposal with which to make investment decisions. In summary, given the recent regulatory developments, the AuSF does not believe that the securitisation of a pool of assets increases the risk associated with such pool of assets so as to then enable the rejection of capital neutrality. Fundamentally, the amount of capital held against a pool of assets should remain the same post securitisation of such assets.

3. Questions

Question 1: The Committee seeks input as to whether the proposed treatment of derivatives other than credit derivatives achieves an appropriate balance between risk sensitivity and simplicity; and welcomes respondents’ views on how to improve upon the proposed treatment.

The AuSF notes that the proposed treatment of derivatives would be simple to apply. However, the AuSF would make the following observations:

1. In the event that a swap ranks *pari passu* with a tranche it should be acceptable to be able to apply the same risk weight as that tranche, rather than the most senior tranche that is junior to the swap

2. The framework document suggests that when calculating K_{IRB} that the positive value of a currency or interest rate swap (from the perspective of the SPE) would be included in the numerator. The AuSF does not agree with this approach fundamentally because derivatives in securitisation transactions have a number of safeguards that prevent the SPE from suffering losses due to a counterparty default, such as obligations on the counterparty to post collateral or novate the derivative in the event that the credit rating of the counterparty deteriorates below certain triggers, and, therefore, it is not necessary to increase the capital charge of a securitisation exposure because of the existence of a derivative in the structure. In addition, the Committee should also note that the mark-to-market of derivatives in securitisation transactions is rarely disclosed to investors and, therefore it would not possible for an investor to make an accurate adjustment to K_{IRB} as contemplated by the framework.

Question 2: While the formulation of the Internal Ratings-Based Approach is much simpler than the MSFA, the Committee recognises that there may be opportunities to make further simplifications by, for example, eliminating one or more of the four variables proposed to calculate “p,” while achieving a degree of risk sensitivity similar to that of the MSFA. The Committee is interested in respondents’ views on ways to simplify the parameterisation of “p”.

The AuSF believes that local regulators should be responsible for the parameterisation of “p” in their own jurisdiction in order to facilitate the imposition of capital charges that are sensitive to the risk characteristics of local asset classes. In the AuSF’s view, this flexibility will be required in order for local regulators to align the application of the new Internal Ratings-Based Approach for securitisation with their approach to the risk-weighting of underlying asset classes under the existing IRB approach for those assets. Local regulators need to be able to amend formulas to produce capital charges that are consistent with the performance (and current capital charges) of local asset classes as the historical loss and performance of certain asset classes differs fundamentally from jurisdiction to jurisdiction. The AuSF welcomes the additional emphasis on the important role of local regulators in applying the new securitisation framework. However, the AuSF recommend a more explicit delegation of the formulation of “p” by the local regulator in each jurisdiction for the reasons outlined above.

Question 3: If respondents favoured a pro rata calculation of the maximum capital requirement, the Committee would welcome arguments that justify that a pro rata cap would result in appropriately conservative capital requirements.

The AuSF agrees that the pro rata cap would result in appropriately conservative capital requirements.

4. Excessive capital requirements

The AuSF welcomes that the Committee has sought to lower the capital charges applied to securitisation exposures from the first consultative document. However, the AuSF is still of the view that the proposed capital charges do not reflect the credit experience of the securitisation market, nor are they reasonable in the context of the underlying assets.

4.1. Default experience

Australian prime RMBS performed with no losses or charge-offs on any rated note, prior to, during and after the global financial crisis. Only one sub-prime note rated by S&P experienced charge-offs and that note was rated 'B' at inception² (a rating which would attract a risk weight between 310% and 420% under the current ERBA approach).

4.2. Appropriate risk weights based on global default experience

That Australian prime RMBS has performed well through the global financial crisis can in part be attributed to the fact that Australia did not suffer a recession and unemployment remained low. The same could not be said for many European countries, which suffered serious recessions and unemployment. However, a S&P study of European securitisations³ outstanding in mid-2007 shows that by Q1 2013 only 0.99% of exposures with a rating of AAA in mid-2007 had defaulted. This includes CDOs and other structured credit, which bore the brunt of the defaults. The default rate for all consumer-related securitisations (not just AAAs) was just 0.04%.

The AuSF suggests that new asset classes or structures could require higher amounts of capital until they have demonstrated a track record through the economic cycle. This would assist in distinguishing between asset classes with a long record through economic cycles and avoids applying capital based on the lowest common denominator.

² S&P: An Overview of Australia's Housing Market and Residential Mortgage-Backed Securities, 27 August 2012

³ S&P Transition Study: Less Than 1.5% of European Structured Finance Has Defaulted Since Mid-2007, 11 June 2013

4.3. Capital held on balance sheet

The AuSF supports the principle of capital neutrality; that is, once a pool of assets has been securitised, the sum of the capital held post securitisation should not be materially greater or lower than the capital held before securitisation. The proposed capital charges materially breach this principle.

Using Australian mortgages as an example, if a bank were to securitise a portfolio of mortgage loans, and tranche them according to a typical Australian RMBS structure, the ERBA risk weight is 25% for a AAA tranche, if the view is taken that the bank does not have knowledge of the composition of the underlying exposures at all times. Therefore, after structuring and credit support (which provides protection against losses far in excess of the historical performance of Australian residential mortgages⁴), the capital charge on the much lower risk AAA piece is only 29% less than if the assets were held on balance sheet (assuming the bank is using Standardised Approach for the underlying residential mortgages). The total capital charge under the ERBA is 1.5 times the capital charge assuming no securitisation, as shown in the example below of a typical transaction. To the extent that a bank is able to use the IRB approach for the underlying residential mortgages then it may well be the case that the capital charge for the underlying mortgages is lower than the capital charge for the AAA piece, let alone the whole RMBS structure.

Tranche	Rating	Weighted Av Life	\$	ERBA
A1	AAA	2	200	25%
A2	AAA	3	211	25%
A3	AAA	5	49	25%
B	AA-	6	30	150%
C	N.R.	10	10	1250%
			500	57%
On-balance sheet risk weight (Standardised Approach)				35%
ERBA as a multiple of on-balance sheet risk weight				1.5

There will be significant flow-on effects – outlined in Section 6 – if this approach is adopted.

⁴ Moody's RMBS Performance Review Q3 2013 notes that: overall gross losses for Australian prime RMBS are still very low. The worst performing vintage of 2004 has incurred 0.41% of gross losses, the majority of which has been covered by lenders mortgage insurance.

4.4. Capital caps

The proposal to cap the maximum risk weights for senior securitisation exposures and that in the event of the risk weight cap resulting in a lower risk weight than the floor of 15%, the risk weight from the cap should be used is noted. In the case of low risk weight pools (such as prime residential mortgages) this may reduce further the amount of capital charges post securitisation. However, the amount of capital charges post securitisation is still materially higher than pre securitisation. This is shown in the table below which assumes that a bank using the IRB approach for the underlying pool is able to achieve a 15% risk weight on the underlying residential mortgages. In particular, for the senior tranches it still fails to recognise structuring and credit support that should, in the AuSF's opinion, enable a senior tranche to be granted a risk weight lower than the overall pool. It also assumes that the institution seeking to apply the cap has sufficient knowledge of the composition of the underlying exposures at all times to be able to calculate the underlying risk weights.

Tranche	Rating	Weighted Av Life	\$	ERBA
A1	AAA	2	200	15%
A2	AAA	3	211	15%
A3	AAA	5	49	15%
B	AA-	6	30	150%
C	N.R.	10	10	1250%
			500	48%
On-balance sheet risk weight				15%
ERBA as a multiple of on-balance sheet risk weight				3.2

4.5. Changes since the financial crisis

During and after the financial crisis, many changes have been made to improve the processes leading to and including securitisation, all of which are expected to reduce rating migration and default. Credit underwriting standards have been improved; there is significantly increased regulation of the credit markets; retention of risk and disclosure requirements have been introduced; and rating agencies have revised their ratings criteria for structured finance transactions which have resulted in significantly increased credit enhancement requirements. When taking these improvements into account it could be argued that capital charges for securitisation should not be

increased which is what will occur if the draft securitisation framework is implemented in its current form.

4.6. Conclusion and AuSF view

The AuSF believes that capital charges are still far too high, particularly for low risk positions such as consumer asset classes (for example, Australian RMBS). It does not reflect actual or reasonable potential default experience and is not reasonable in the context of capital requirements if assets are held on balance sheet.

5. Reliance on external ratings and hierarchy of approach

The Basel Committee's first stated objective in this consultative document is to reduce mechanistic reliance on external ratings. The AuSF is sympathetic to this objective and agrees with the hierarchy of approach set out in the draft framework. The AuSF has the following observations on the rating approaches proposed in the draft framework.

5.1. IRB

The AuSF is concerned that the IRB formula does not provide sufficient credit to structuring and credit support provided in securitisations. For example, the AuSF notes that for non-residential mortgage retail portfolios in particular, such as auto loans, the formula produces a capital charge for securitisation exposures which is inconsistent with the historical experience of the asset class and the credit support contained within. The AuSF has modelled the capital charge for a AAA rated, senior exposure for a hypothetical Australian auto loan securitisation. The IRB formula produces a risk weight far in excess of what should be required given the historical default experience of such asset classes and the amount of credit support. The IRB model seems to place more weight on maturity (and K_{IRB}) as opposed to the amount of credit support (attachment point). Section 9 below sets out in more detail the AuSF concerns about the inclusion of maturity in the formula.

5.2. ERBA

We have provided comments on the level of risk weights in Section 4 and reiterate that the AuSF believes them to be too high. The AuSF welcomes the Committee decision to reduce the number of required rating agencies from two to one.

5.3. SA

The AuSF has similar concerns in respect of the SA formula that it has set out above with regards the IRB formula. The formula gives rise to capital charges far in excess of what should be required given the historical default experience of such asset classes and the amount of credit support. In addition, the inclusion of “W” in the formula fails to recognise that securitisation structures may have the benefit of credit enhancement other than subordination. For example, in non-residential mortgage retail portfolios, it is not unusual to have relatively high levels of delinquency, but these are matched by high levels of excess spread that is more than sufficient to cover losses incurred.

5.4. Local Flexibility

To the extent that the Committee decides to retain the approach to capital charges set out in the draft framework it should, in the AuSF’s opinion, allow local regulators some flexibility to change the inputs into the formulas. This would then allow local regulators to amend formulas to produce capital charges that are in line with the performance of local asset classes, which may differ from global experience.

6. Consequences on securitisation – a material diminution of the securitisation market

If the proposed risk weights were implemented, the AuSF would expect to see a significant diminution of the securitisation market. As noted in the examples in Section 4, the capital required to hold securitisation tranches is at least 1.5 times that to hold assets on balance sheet. The increase in capital charges for AAA rated securitisations is likely to have a significant impact on the Australian securitisation market, as noted in Section 1, c.75% of Australian securitisation investors are banks and it is likely that would expect these buyers of AAA tranches of securitisations to prefer to fund mortgages directly. This would adversely impact banks and non-banks that utilise securitisation as a material funding source by reducing bank balance sheet investors in these transactions.

In theory, spreads could rise to compensate banks for the extra capital. However, the proposed risk weight of 25% for a AAA tranche is more than 3 times the existing risk weight of 7%. Therefore

spreads would have to rise significantly to receive an equivalent return on equity. A material increase in spreads leads directly to a material decrease in issuance.

During the course of the financial crisis, the securitisation market was effectively closed to new issuance. This meant smaller banks and non-bank lenders had difficulty in funding their existing and new portfolios. The Australian Government recognised this reduction in competition and directed the Australian Office of Financial Management (a branch of the Australian Treasury) to invest in RMBS issued by smaller banks and non-bank lenders.

An increase in risk weights of the level proposed by the Committee could lead directly to a large reduction in the securitisation markets with a consequent reduction in competition and innovation for Australian borrowers.

7. Resecuritisation

The AuSF welcomes the clarification of the definition of a resecuritisation exposure. However, it is still not clear as to the AuSF whether the use of double trust exposures and investing in unrelated ABCP are excluded. In the AuSF's view neither increase correlation risk, however gaining more clarity on this would be appreciated.

8. Transition / Grandfathering

The AuSF notes that it is the Committee's intention to not include grandfathering provisions in the final standard. The AuSF is concerned that given there is still a level of uncertainty around the form of the final standard industry is therefore uncertain how to structure transactions and whether they should be undertaken at all. Instead, the AuSF requests that all securitisation exposures existing at the date of implementation of the new standards be grandfathered under the existing requirements, both as to methodology and capital requirements. The AuSF is concerned that if relief is not granted, that it may have a material impact on the industry until such time that the final standard is released and significant capital volatility could occur, including the cliff effects that the Committee seeks to avoid under the proposals. If the Committee is unwilling to allow full grandfathering the AuSF believes it should consider an approach similar to the approach the Committee has taken for liquidity and capital requirements i.e. a phased approach with example reporting requirements ahead of full implementation.

9. Maturity

The AuSF supports the concept of maturity being included as a parameter in the calculation of capital requirements, as it is in the IRB calculations. However, the AuSF has three concerns with the consultative document's proposals.

1. Maturity is already explicitly taken into account in the assignment of ratings by an external rating agency or in internal ratings assessments. To add maturity again in the ERBA is to double count the effect. Therefore maturity should not be included in any approach in which it has already been taken into account, particularly the ERBA.
2. Despite reservation from the AuSF and others, the consultation document still proposes to calculate maturity by reference to contracted cash flows of the securitisation exposure. Pass-through exposures typically have no contracted capital payments until the legal final maturity and yet provide predictable principal repayments based on the contractual payments due from the underlying assets. Even tranches expected to pay out fully in fewer than five years will automatically be subject to the five year cap, as the contracted cashflows differ from the reasonably expected ones. The AuSF submits that maturity should take into account repayments and reasonable prepayments on the underlying assets and be calculated according to a weighted average maturity methodology. This methodology is standard in the securitisation market and is used to price transactions.
3. As set out in Section 4, the AuSF believes that the proposed capital requirements are too high. Applying a maturity multiplier to a starting level of capital that is too high magnifies the initial concern.

10. Summary of AuSF recommendations

Recommendation	Section
In the event that a swap ranks <i>pari passu</i> with a tranche it should be acceptable to be able to apply the same risk weight as that tranche	3
The positive value of a currency or interest rate swap (from the perspective of the SPE) should not be included in the numerator of K_{IRB}	3
The amount of capital held against a pool of assets should remain the same post securitisation of such assets	3 & 4
Local regulators should have the flexibility to amend model inputs so as to produce capital charges that reflect the performance of local asset classes	3 & 5
Capital requirements should reflect actual or reasonable potential default experience	4
The IRB and SA formula should place greater weight on credit support (subordination) as opposed to other factors such as maturity	5
“W” in the SA formula should be eliminated, or at least be able to be adjusted to take into account enhancements such as excess spread	5
Transitional relief should be granted for all transactions from the date of implementation of the new standards	8
Maturity should not be included in the ERBA	9
Maturity should take account of repayments and reasonable prepayments	9