International Banking Federation

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Secretariat of the Basel Committee on Banking Supervision
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Dear Sir/Madam

Re: ***Response to the second consultation on revisions to the Basel securitisation framework***

The IBFed appreciates the opportunity to comment on the Basel Committee on Banking Supervision (the Committee) proposal to revise the Basel securitisation framework. We note that IBFed members will individually submit responses highlighting specific impacts to their respective securitisation markets, which we urge the Committee to take into full consideration when further developing its framework.

Overall, we appreciate that the second consultative document incorporated changes based on the industry's comments to the first draft. We support the simplified hierarchy of approaches proposed in the consultative document in that it (a) reflects the concept of "Alternative A" that was proposed in the first consultative document, and (b) places the risk-sensitive Internal Ratings-Based Approach (IRBA) at the top of the hierarchy.

Nonetheless, we believe that some issues need further consideration, such as re-calibration of the underlying models particularly as it pertains to traditionally structured (i.e. minimum risk transfer) AAA-rated senior tranches with high-quality underlying assets. We believe that securitisation exposures that are currently in place should be grandfathered. We would also welcome greater transparency on the assumptions used by the Committee in calibrating the revised risk-weights of the different approaches.

While the IBFed is not able to respond in detail to this response as the securitisation markets are quite different across jurisdictions, we would like to provide some high level messages outlined below.

Re-calibration of risk weights

We believe that much could be gained by: (1) having greater clarity and discussion on the assumptions used by the Committee in calibrating the revised risk-weights of the different

approaches, and (2) ensuring that further re-calibration of the underlying models is undertaken and informed by the outcome of the quantitative impact assessments.

While we are supportive and appreciative that the calibration for the underlying models has been revised since the release of the first consultative document, we request that further adjustments be made. In particular, we believe that a 25% risk-weight under the External Ratings-Based Approach (ERBA) for an AAA-rated senior exposure with a 5-year maturity is still too punitive. As most tranche maturities are closer to 4 or 5 years (particularly given the proposed definition of Tranche Maturity) than 1 year, the "effective" risk-weight floor under ERBA is much closer to 25% than 15%. Hence, the true or "effective" floor for banks that apply ERBA will be more than triple the 7% risk-weight floor under the current framework. We believe that the tripling of the floor is overly punitive.

Different calibration for high-quality assets

We are concerned that some of the conservatism in the proposed calibration stems from the need to find a calibration that works for all kinds of securitisations, without being able to take certain qualitative characteristics into account. As an example, the European Insurance and Occupational Pensions Authority (EIOPA), in a Technical Report on Long-term Investment[1], proposed a definition of high-quality securitisations (i.e. 'Type A' securitisations) that benefit from lower capital requirements. Perhaps a similar definition could be developed in the Basel securitisation framework, where the assessment could include the following characteristics:

- No severe claw-back provisions
- Servicing continuity
- Eligible underlying assets: (i) prime conventional residential mortgages; (ii) loans to small and medium-sized enterprises (SME); (iii) prime auto loans; (iv) leasing; (v) consumer finance and (vi) credit card receivables
- Type of underlying assets
- No credit impairment
- No non-performing loans

We would welcome further discussion on the characteristics of a "good" securitisation structure and how it could be operationalized.

Floors on highly-rated senior tranche securitisation exposures with high-quality pools as underlying

While we welcome the lowering of the floor from 20 - 58% to 15 - 25%, we still believe this floor is misaligned with the low-risk/low-default nature of asset-backed and mortgage-backed securities (ABS/MBS) in the most liquid and resilient sectors, such as prime conventional residential mortgage-backed securities (RMBS) or prime auto ABS. We believe that the Committee's conclusion that "*capital requirements for highly rated securitisation exposures proved to be too low, in light of the performance during the crisis*":

[1] Technical Report on Standard Formula Design and Calibration for Certain Long-Term Investments, EIOPA, 19/13/2013

(a) Does not consider the performance of the above ABS assets during the crisis and thereby erroneously treats “good” and “bad” highly-rated ABS equally; and

(b) Misses the multiple actual drivers for the performance (including potential wrong assessment) that should inform the formulation of the risk weights (i.e. we believe that relating performance and risk weight without taking into account the factors driving the performance is too simplistic).

The maturity-scaled floor of 15 - 25% has been set at a level well beyond what is needed to absorb the worst-case stressed loss experience on traditionally structured (i.e. structures with minimal risk transfer) senior exposures to high-quality assets, and as such, undermines Basel’s risk-sensitivity objective. As a consequence, in our view, the Committee fails to strike the important balance between risk sensitivity and simplicity of implementation. We encourage the Committee to re-calibrate the underlying models so that adequate risk sensitivity is achieved in the capital requirements assessment for traditional securitisation structures with high-quality underlying assets (such as prime conventional residential mortgages and auto loans). A one-size fits-all capital floor fails to incentivize prudent underwriting, which could result in unintended risk-taking behaviour. At a minimum, risk-weight calibration needs to be set such that a senior securitized exposure attracts a lower charge than if the asset is held by the bank without the support of credit enhancements available to it in the securitisation.

Lower risk-weight floor for senior tranche short-term transactions

We believe that the risk-weight floor of short-term transactions should be lower than the proposed 15%. The existing capital requirements for the senior most tranches has proven to be more than adequate to cover stressed losses both during the credit crisis and in the 4 – 5 years since that time. Historical performance has proven that asset-backed commercial paper (ABCP) and asset-backed lending (ABL) programmes, where the maturity of both the underlying assets and tranches is one year or less, are highly likely to be redeemed even during periods of global financial stress. The structures of these short-term programmes results in minimal default/loss because (a) they are structured to provide sufficient credit enhancement to withstand stressed losses, and (b) the underlying assets are typically of very high quality. Further, the company that sells the receivables to the conduit is at all times capable of obtaining information about credit worthiness of their customers, and hence may immediately respond to any default of individual receivables, if it occurs, by replacing their underlying assets. As a result, the credit worthiness of underlying pools can be maintained at an acceptable level.

In finalizing the revised securitisation framework, we encourage the Basel Committee to be mindful that the losses experienced by banks during the financial crisis were predominately generated by subprime RMBS that did not benefit from current risk retention guidance and some leveraged collateralized debt obligations (CDO) structures. We submit that the new proposed framework needs to recognize the root causes of this differentiation of both asset quality and market structure, and preserve the risk-sensitivity that has allowed the market to adjust and re-focus on the better performing asset types and more traditional securitisation structures that have minimal risk transfer. We believe that the quantitative impact study (QIS) will confirm the preliminary assessments already made by the industry: that the revised proposals continue to disproportionately penalize the best performing securitisations –

traditionally structured (i.e. structures with minimal risk transfer) senior exposures to high-quality assets – and by doing so, risk the banks' ability to continue economically participating as a source of credit to this important segment of the economy.

We request that the Committee take into account the above facts for the above programmes and other transactions where the maturity of both the underlying assets and tranches is one year or less. We believe that the current 7% risk-weight floor is more appropriate than the proposed 15% risk-weight floor.

Maturity in static pool transactions

The definition of maturity remains very conservative. In the current proposal, either legal maturity or the weighted average contractual cash flows of the tranche can be used; however, it is very unusual for a securitisation tranche to have contractually fixed payments (i.e. fixed amounts on fixed dates). Therefore, the second alternative could hardly be used, and almost always the final legal maturity, which is only very vaguely connected to the effective maturity, would have to be used.

On the other hand, in static pool transactions, the cash flows of the underlying portfolio are often contractually fixed (e.g. amortising loans). For such transactions, we propose to use the contractual maturity profile of the pool and transfer this one-to-one to the tranches of the securitisation (i.e. without any credit to prepayments or other effects). This approach would allow using a definition that will be close to the actual maturity of a static pool securitisation, while still being conservative and free of model risk in the form of assumptions regarding prepayments or other factors.

Maturity in replenishing transactions

Similar to static pool transactions, the definition of maturity for replenishing transactions seems very conservative. In the current proposal, the longest possible maturity of any asset added to the pool during the replenishment phase has to be added to the remaining replenishment period. Given the uncertainties in the calculation of maturity in replenishing transactions, we propose to take into account contractual safeguards where they exist. If, for example, the weighted-average maturity (WAM) of the replenished pool (without any credit to prepayments or other effects) is contractually limited to a certain value, then this term is used instead of the longest maturity of any single asset. This definition would follow the concept that only contractually documented values can be used, but the resulting value would be much closer to the actual realised maturity of a replenishing securitisation. Since the limit on the WAM is only a maximum value, this definition still would be conservative.

Definition of re-securitisation exposure

This issue is relevant for banks that provide both liquidity facilities and program-wide credit enhancement facilities to ABCP conduits. Banks that currently utilize either the Internal Assessment Approach (IAA) or the Supervisory Formula Approach (SFA) assign a risk-weight to the backstop liquidity commitment supporting the securitisation exposure in a manner that:

- Assumes the bank owns the underlying securitisation (i.e. there is no conversion factor to reduce the risk weights below direct ownership), and

- Does not recognize the benefit of structural protections afforded to liquidity providers (e.g. the requirement to not fund defaulted receivables).

In essence, the capital assigned to the liquidity facility is at least as conservative as the capital that is assigned to funding the exposure directly on the bank's balance sheet. The current proposal requires that banks capitalize the program-wide credit enhancement as a re-securitisation (note: the sum total of backstop liquidity facilities and program-wide credit enhancement exceeds 100% of the ABCP conduit liabilities). As a result, the sum total of the regulatory capital associated with the liquidity facilities and program-wide credit enhancement facility supporting the ABCP conduit far exceeds the regulatory capital that a bank would be required to hold if it simply guaranteed each and every asset funded by the ABCP conduit.

The impact of this re-securitisation approach is an excessive and inconsistent regulatory capital requirement when compared to the regulatory capital that would be required for the liquidity facilities (which are treated as if banks owned the related securitisation directly on the banks' balance sheets). We therefore recommend that the regulators make it clear in the IAA that when banks provide greater than one hundred percent committed facilities in support of an eligible ABCP conduit that they not be required to hold more regulatory capital than if they were to fully guarantee each of the underlying transactions that the ABCP conduit has entered into (the IAA Regulatory Cap).

Standardized Approach (SA) assets in IRBA

We welcome that the new proposal allows for transactions to use the IRBA for mixed pools of IRBA and SA assets. However, the need to apply the risk weight of 1250% to the SA assets adds a severe level of conservatism even for transactions that almost solely consist of IRBA assets. To avoid this, we propose to use the risk weights from the general standardised approach for these assets up to a threshold of 5%, and only then apply the risk weight of 1250% to the assets that surpass this amount.

Treatment of derivative contracts other than credit derivatives

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 respondent's views on how to improve upon the proposed treatment.*

Although more analysis is required, we see the proposed treatment of derivatives as a good compromise. However, we have concerns on the treatment required where a bank only has a derivative exposure to the securitisation, and that no external rating is available to the tranche that is junior to the swap exposure. In this situation, getting the required underlying information to assess the IRBA or SA might not be feasible, leading to a 1250% risk weight on the EAD. Depending on the thickness of the most senior tranche that is junior to swap, the swap exposure can have very different ratings under the proposed rules. This does not reflect the waterfall structure specific to swap breakage cost. We believe that the treatment for interest rate swaps requires additional consideration and should address termination payments and on-going payments in the normal course.

Internal Ratings-Based Approach

***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".*

We are pleased to see that sufficient latitude to apply IRBA is being provided to non-originating banks that only have access to pool-level data and that can only validate/back-test at the pool level. The ability to apply IRBA will incent non-originating banks to perform their own internal assessments of securitisation exposures, which in turn will enhance their risk measurement and management practices. This, we believe, will result in a safer and more resilient banking industry.

Regarding the calculation of "p", we offer the following comments:

- What is the empirical basis for the calibration of the "p" parameter? It is difficult to offer a recommendation on how to calculate "p" when we do not know how the calculation was derived. The capital results are highly sensitive to the calibration of the "p" parameter particular for senior tranches.

- We note that the proposed calculation for the "p" parameter could make it challenging for non-originating banks to apply IRBA. Indeed, the parameters "N" (i.e. effective number of exposures in the underlying pool) and "LGD" (i.e. weighted-average Loss Given Default of the underlying pool would require Exposure at Default (EAD) and Loss Given Default (LGD) to be calculated at the loan-level. This loan-level data is not available to bank investors that invest in most traditional, granular ABS, such as retail ABS or RMBS, and small commercial ABS. As we believe it is not the Basel Committee's intention to require non-originating banks to have the same level of information as originating banks in order to apply IRBA, we request that the "p" factor calculation be modified so that it does not inhibit a non-originating bank from applying IRBA.

- We also note that a negative parameter assigned to K_{IRB} in the "p" parameter calculation implies that higher underlying risk leads to a lower "p" value, which is counterintuitive. Based on proposed calibration, the "p" parameter for non-senior tranche can be lower than for the senior tranche, which is counterintuitive.

Where the internal ratings-based approach (IRBA) is used, the sensitivity of the input tranche maturity (Mt) differs significantly between wholesale and retail underlying assets. For retail, when assuming that other conditions are constant, the sensitivity of Mt (particularly in the case of "Mt>3 years") to risk weight becomes high, giving rise to the following concerns:

- cliff effects might arise in terms of risk-weights once exceeding a certain Mt threshold; and
- senior tranches with high Mt could result in considerably higher risk weights than those determined under the external ratings-based approach (ERBA), though a reversal of conservatism would not be intended by BCBS.

Changes to original proposal

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

Could the Basel Committee provide more clarification on how the pro-rata calculation will work? How would a bank pro-rata a senior tranche with mezzanine debt that is the bulk of the risk, but the smallest portion of the nominal base. If you hold more than 1 tranche that includes senior and mezzanine debt, how will a bank determine an accurate level of the risk it is assuming?

National Discretion

There are several references in the consultation document to standards put in place by certain jurisdictions or national supervisors (e.g. calculation of K_{IRB} or the application of the IAA for mixed pools). Given the differences that exist in securitisation markets across jurisdictions and the greater familiarity that local supervisors have with the risks undertaken by banks within their oversight, we encourage ample national discretion (via a principles-based approach) be given to specific "targeted" topics, such as the ability for a non-originating bank to apply IRBA. However, outside of these "targeted" topics, we believe that uniformity of rule implementation is necessary in order to achieve fair competition between institutions that reside in different jurisdictions.

To allow banks to apply the IRBA to both their investment and banking book exposures, the securitisation framework needs to be flexible enough to adjust for the differing levels of pool granularity that is practically available in support of these two fundamentally different risk-taking activities. We appreciate and support the emphasis the Committee has introduced in the revised proposals on discussions between banks and their local supervisors in establishing practical standards that avoid arbitrage opportunities and encourage consistent risk assessment and monitoring practices for both types of activities.

Implementation period

Grandfathering and a delayed effective date are critical issues for existing securitisation structures. We believe exposures currently held by banks that have been priced and valued in good faith to support existing cost structures should be grandfathered to avoid harmful and unnecessary valuation adjustments – absorbed either by bank clients through facility re-pricing or banks through material profit deterioration. In particular, we believe that the early amortization provision revisions (page 17 in the consultative document) should only apply to securitisation transactions that are originated after the revised securitisation framework has been implemented so that bank originators that have existing ABS/MBS notes outstanding can continue to realize the capital relief from securitizing their revolving credit exposures, which is what was expected/priced at the time of issuance. It should be noted that a substantial amount of these originated funding transactions that are securitised with revolving credit exposures are expected to remain outstanding at the estimated implementation date of the revised securitisation framework, and so we believe that in the absence of grandfathering, the change in capital relief can have a material impact.

If grandfathering is not permitted, given the potentially punitive requirements, we believe the implementation date should be extended far enough into the future to allow banks sufficient

time to readjust portfolios and structures and for capital-raising clients to adjust their funding strategies. The absence of grandfathering will create either a drastic increase in bank capital requirements or a material re-financing of existing securitized asset pools once the new framework becomes effective. Consequently, sufficient time is needed in order to retain business relationships with customers and adapt portfolios for the final standard.

Conclusion

While we appreciate the second consultative document's improved hierarchy approach and greater consistency with the underlying credit risk framework, we believe that there needs to be a better balance between risk sensitivity and simplicity. We suggest that the QIS results be used to re-calibrate some of the underlying assumptions and that sufficient time be allocated to implement the new securitisation framework.

We thank you for taking our comments into consideration and look forward to future discussions on these issues.

Yours sincerely

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