

Secretariat of the Basel Committee on Banking Supervision  
Centralbahnplatz 2  
Bank for International Settlements  
CH-4002 Basel  
Switzerland

March 21, 2014

Dear Sirs

### **Standard & Poor's Response To The December 2013 Consultative Document On Revisions To The Basel Securitization Framework**

Standard & Poor's Ratings Services ("S&P") appreciates the opportunity to respond to the Basel Committee on Banking Supervision's ("the Committee") second consultative document on revisions to the Basel securitization framework, dated Dec. 19, 2013 (the "December 2013 Consultation Paper").

We believe that banking regulation remains one of the key factors shaping the future of securitization markets—particularly in Europe, where banks are heavily involved in the securitization process as originators, investors, and supporting counterparties. Our analysis suggests that the implementation of the December 2013 Consultation Paper's proposals would have a significant effect on banks' capital requirements for securitization exposures.

In our view, the revised proposals are an improvement on the previous proposals made in December 2012. For example, the revised proposals are less complex and generally lead to lower risk weights for banks' securitization exposures than the previous proposals. In our view, these risk weights are somewhat more consistent with the credit performance of most global securitization asset classes.

However, the revised proposals do not fully address our concerns regarding the initial proposals from December 2012, which we reiterate below:

- In seeking to reduce the framework's reliance on external ratings, the proposals increase its reliance on various formula-based approaches. These generally do not take into account the full range of factors that can affect the creditworthiness of a securitization exposure, in our view, potentially undermining the framework's risk sensitivity.
- While simpler than the initial proposals, the framework presented in the revised proposals still includes at least three different approaches to calculating securitization capital charges. The different approaches often result in significantly different capital charges, so there remains significant scope for inconsistencies in treatment between different banks and/or jurisdictions, in our view. In particular, the

proposals could exacerbate the already "uneven playing field" between banks that use the internal ratings-based (IRB) approach for the securitization's underlying assets, and those that do not.

- Notwithstanding the Committee's aim of ensuring more prudent capital charges for some securitization exposures, we question whether the losses experienced by securitizations globally since the 2007-2008 financial crisis warrant the scale of increase in capital charges that the proposals would result in for senior tranches.
- Our analysis suggests that in many situations, the External Ratings-Based Approach (ERBA) leads to significantly higher capital charges than the other proposed approaches, which suggests the ERBA may be incorrectly calibrated.
- Although the proposals envisage capping and flooring mechanisms to mitigate the risk of excessively high or low capital charges, our analysis suggests that these caps and floors could determine capital charges in many situations, rather than being an exception. This undermines the overall framework's risk sensitivity, since different tranches with divergent characteristics and risk profiles may often be subject to the same capital charge, due to the application of a cap or floor.

Our detailed responses are set out in Appendix 1 below. In order to illustrate and quantify some of our concerns, we have applied the various capital calculation methodologies proposed in the December 2013 Consultation Paper to a sample of stylized securitization tranches, based on real outstanding European and U.S. transactions that we rate. Appendix 2 provides details of these transactions.

We would be pleased to discuss any of the matters we have raised with you further. If you have any questions or require additional information, please contact Bernard de Longevialle ([bernard.delongevialle@standardandpoors.com](mailto:bernard.delongevialle@standardandpoors.com), +1 917 628 3263) or Andrew South ([andrew.south@standardandpoors.com](mailto:andrew.south@standardandpoors.com), +44 20 7176 3712).

Yours faithfully



Bernard de Longevialle  
Standard & Poor's Ratings Services

## Appendix 1

Below we provide our more detailed comments on the Committee's revised proposals.

### **The Revised Proposals Include Several Improvements, But Some Concerns Remain**

In our view, the revised proposals in the December 2013 Consultation Paper are an improvement on the initial proposals made in December 2012. For example, the initial proposals included two alternative hierarchies of approaches, each containing four or five different methods to calculate capital charges for term securitization exposures, with the applicable method depending on a combination of the bank's choice, jurisdiction, data availability, and/or whether the securitization exposure was deemed to be "senior and high-quality". By contrast, the revised proposals include a far simpler single hierarchy of three calculation approaches for term securitization exposures.

Despite these improvements, the revised proposals still have a number of limitations, in our opinion, which we discuss below.

#### ***The risk sensitivity of formula-based approaches is intrinsically limited***

S&P understands that one of the Committee's aims is to mitigate the mechanistic reliance on external ratings in the securitization framework. However, in our response to the December 2012 Consultation Paper, we noted that the proposed alternatives to a ratings-based approach increase reliance on mechanistic formulae with a limited number of inputs, rather than a combination of qualitative and quantitative risk assessments. These formula-based approaches may lead to significantly reduced risk sensitivity and unintended consequences.

In the revised proposals, the Internal Ratings-Based Approach (IRBA) and the Standardized Approach (SA) remain strongly formula-based, with the resulting capital charges generally depending on only a limited number of input parameters, including some of the underlying asset pool's risk characteristics, and the tranche's attachment point, detachment point, and maturity.

In the IRBA, such inputs could potentially allow for some analytical judgment or qualitative assessment, through the bank's methodology for determining the underlying portfolio risk parameter, known as "KIRB". However, the IRBA in the proposed securitization framework then uses KIRB and other inputs to mechanically infer a risk assessment—and hence capital requirement—on the related securitization exposures. The proposed SA follows a similar methodology, but uses more standardized inputs for the underlying asset pool's risk characteristics.

In our view, both of the remaining formula-based approaches—the IRBA and the SA—are limited by implicitly assuming that the credit risk of securitization exposures is solely a function of the potential for losses in the underlying asset pool. In reality, we believe there are many other factors to consider—both positive and negative—when assessing the

creditworthiness of a securitization exposure, which such formulaic approaches cannot practically capture. These include legal risk, operational risk, counterparty risk, country risk, as well as numerous other structural features—such as excess spread mechanisms and interest rate and/or currency mismatches—which may affect cash flows to the securitization exposures and their ultimate loss propensity.

The December 2013 Consultation Paper acknowledges some of these considerations. For example, we understand that when calibrating the revised proposals, the Committee recognized excess spread as a risk mitigant more than in the initial proposals. That said, we note that the IRBA and SA formulae do not differentiate between transactions with differing levels of excess spread, and we understand that this has only altered the overall calibration.

The December 2012 Consultation Paper did not discuss the treatment of interest rate or currency mismatches between the underlying assets and a securitization exposure, nor the derivatives contracts—such as interest rate or currency swaps—that securitization issuers commonly enter into to partially offset such risks. This is despite such features having a potentially significant effect on some securitization exposures' creditworthiness, in our view, and therefore on our ratings. By contrast, the December 2013 Consultation Paper briefly acknowledges derivatives contracts—both for cases where the bank is a swap provider in a securitization and where it is investing in a securitization tranche that benefits from derivative-based interest rate or currency hedging.

However, we still believe that the proposed formula-based approaches will not adequately differentiate the risk characteristics of exposures with major differences in such structural features. As an example, consider two securitization exposures with similar capital structures, each backed by floating-rate underlying assets. Exposure A also pays a floating rate coupon, but Exposure B, by contrast, pays a fixed rate. A bank investing in Exposure B is therefore additionally exposed to the risk that—in a falling interest rate environment—the transaction will have fewer resources to cover losses in the asset pool. The formula-based approaches would likely not differentiate capital charges between these two hypothetical exposures. By contrast, more holistic risk assessments—including the methodologies typically used by rating agencies—would consider the difference in risk profiles, and Exposure B would likely be rated lower than Exposure A.

If the issuer of Exposure B now enters into an interest rate swap, in order to mitigate the previous asset-liability mismatch, we may raise our ratings to reflect the lower credit risk of Exposure B, potentially lowering the capital charge under the ERBA. (The degree to which we might raise our rating would depend on many factors, including the swap counterparty's creditworthiness and its replacement and collateral posting commitments in the derivatives contract.) By contrast, we understand that the proposed formula-based approaches would likely increase the capital charge for Exposure B, if the swap has a positive value for the issuer. This approach seems to reflect the risk that a swap counterparty default may be detrimental to the securitization's creditworthiness, but without reflecting the benefits to creditworthiness that the interest rate hedging provides.

We appreciate the Committee's aim of reducing mechanistic reliance on external ratings. However, under the proposed formula-based approaches, the formulae prescribe how a risk assessment on the underlying assets translates into risk for the securitization exposure. This is without explicit reference to many of the structural risks and/or risk mitigants that in practice may significantly affect a securitization's creditworthiness.

***Less divergence in capital charges, but there's still not a "level playing field"***

In our comments on the December 2012 Consultation Paper, we noted that calculated capital charges would diverge widely, depending on which of the several proposed methodologies a bank applies.

We note the degree of this divergence is somewhat lower under the revised proposals, partly due to their including fewer alternative calculation methodologies. However, our analysis suggests that—even under the revised proposals—the same securitization exposure could still incur significantly different capital charges depending on the approach used. The approach would in turn still depend on the jurisdiction and whether the bank operates under the IRB approach on the securitization's underlying exposures. The proposal could therefore still lead to a significantly "uneven playing field"—with material inconsistencies in capital charges for the same securitization exposure between different institutions and countries—and potentially to regulatory gaming.

For example, in our analysis of a sample of securitization tranches, the largest capital charge resulting from the three proposed calculation approaches for a given exposure—IRBA, ERBA, and SA—was a median 3.2 times higher than the smallest capital charge for the same exposure (see chart 1). Here, we ignore the various proposed floors and caps on capital charges and risk weights in order to highlight the differences in the underlying calculation frameworks. Even applying the proposed floors and caps, the median ratio was 2.8 times, and the largest possible capital charge for some exposures (e.g., using the ERBA) was still many multiples of the smallest possible capital charge for the same exposure (e.g., using the IRBA).

Chart 1



For our sample of securitization tranches, the current Basel II framework produces a significantly more "level playing field", with a median ratio between the existing SA and IRB approaches of only one. This is partly because many of the tranches in our sample would receive a 1250% risk weight under both the SA and IRB approaches in Basel II, but even excluding these tranches, the median ratio would be 1.9.

Given the divergence in results from the different approaches, we note that banks using the IRBA may often incur lower capital charges under the proposal than banks using the ERBA or the SA. In our view, this could lead to systematically lower capital charges for bank originators retaining portions of tranches in their own securitizations, for example, than for other banks investing in the same tranches. These other banks are less likely to have the necessary information or modeling frameworks to allow the use of the IRBA in investment securitization exposures.

We therefore continue to question the extent to which the proposals—in aggregate—result in a more risk-sensitive outcome for allocating capital to securitization exposures. While some of the methodologies are presented as modifications to existing approaches in order to

make them more risk-sensitive, the wide range of potential outcomes could make the framework less risk-sensitive overall.

In addition, we still believe that the existence of several approaches with potentially widely-differing outcomes could make the framework vulnerable to regulatory gaming. Although some of the formulae are highly prescriptive, we believe there could be significant room for banks to determine which of their portfolios and securitization exposures qualify for the different treatments in order to optimize overall capital charges.

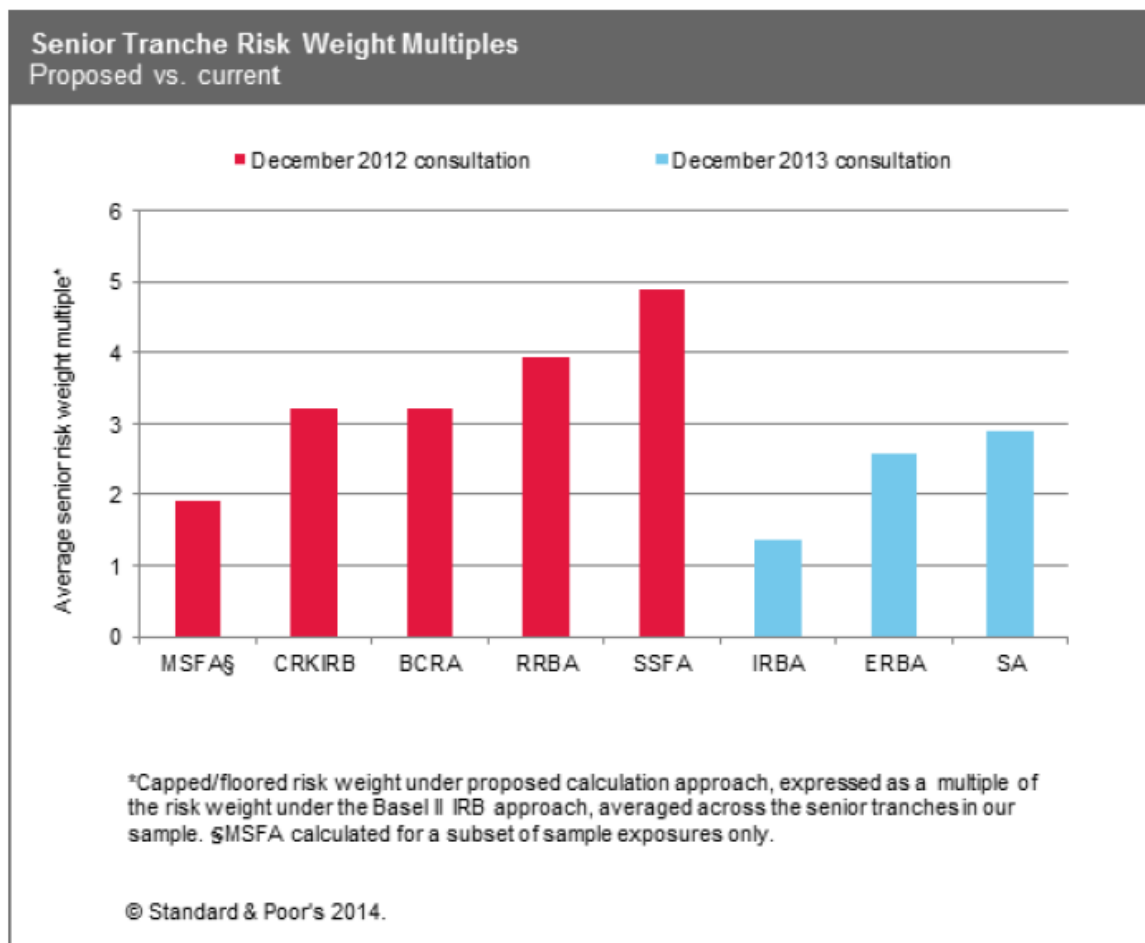
In our view, complexity, national supervisors' discretion, and a variety of bank options in a regulatory capital framework could lead to inconsistencies and a lack of transparency. Even under Basel II, it has become difficult to assess different banks' capital adequacy consistently, based on their regulatory capital reporting. For this reason, we employ our own risk-adjusted capital framework when rating financial institutions.

Once the text is finalized, we encourage the Committee to design a strong set of disclosure standards, to enhance the understanding of external market participants and to allow market discipline, according to the third pillar of the Basel agreement.

***The revised capital charges are lower, but still seem high in the context of performance***

According to our analysis, the calculation framework described in the December 2013 Consultation Paper would generally lead to lower capital charges than under the initial December 2012 proposals. However—for senior securitization exposures in particular—the capital charges would generally remain significantly higher under the December 2013 proposals than under the current Basel II securitization framework (see chart 2).

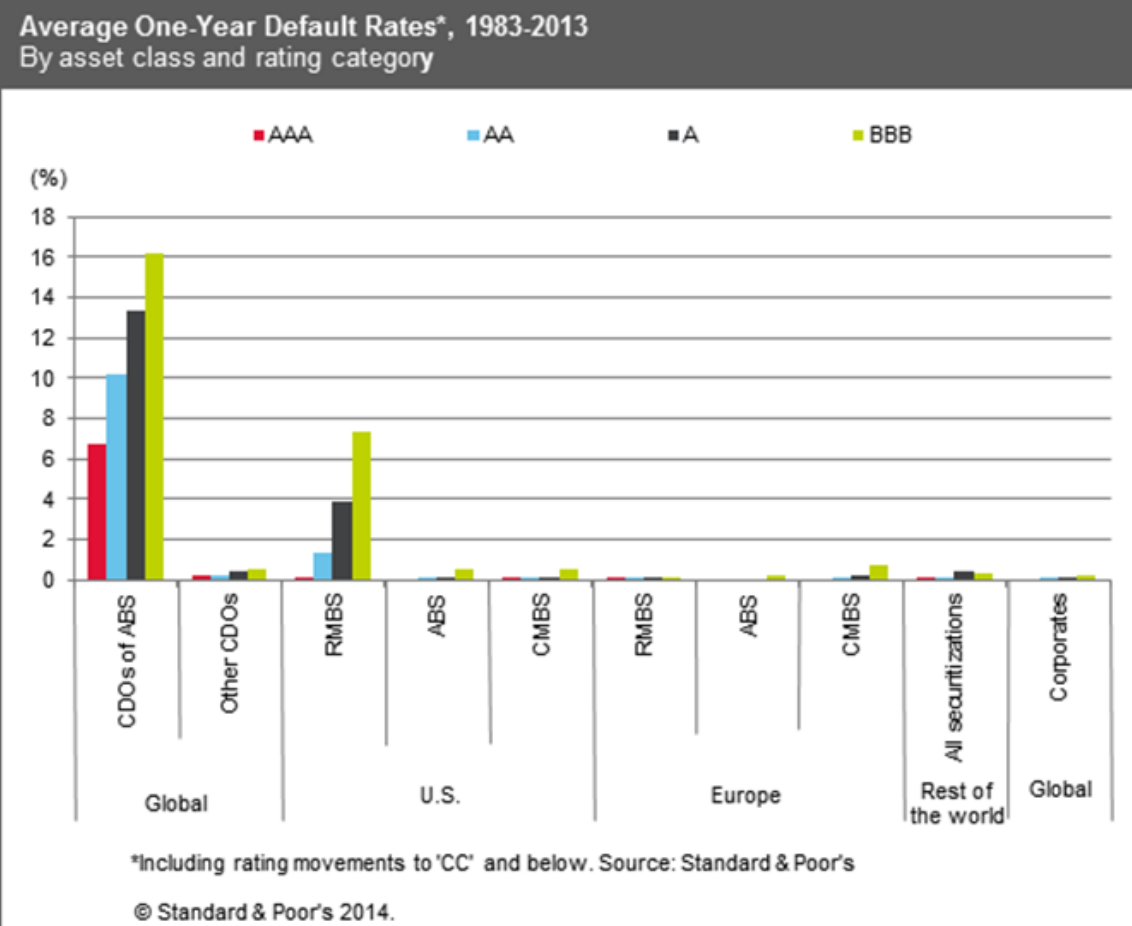
Chart 2



While we understand that some increase in senior exposures' capital charges is one of the Committee's objectives, we continue to question whether the extent of the increase under some of the proposed calculation approaches is consistent with general observations of securitization credit performance over the past several years or with the capital charges that banks would incur if they held the underlying collateral in unsecuritized form. For example, the effective risk weights for our sample of senior tranches under the ERBA or the SA would, on average, be two to three times the risk weights under the current ratings-based approach for an IRB bank.

Although some securitization sectors suffered from unexpectedly poor performance and high losses during the financial crisis, this was limited to those asset classes with exposure to the U.S. housing market, and specifically to subprime mortgage loan collateral. This included U.S. subprime residential mortgage-backed securities (RMBS), as well as collateralized debt obligations that repackaged some of these asset-backed securities—so-called collateralized debt obligations (CDOs) of ABS. However, most global securitization sectors performed well during the crisis (see chart 3).

Chart 3

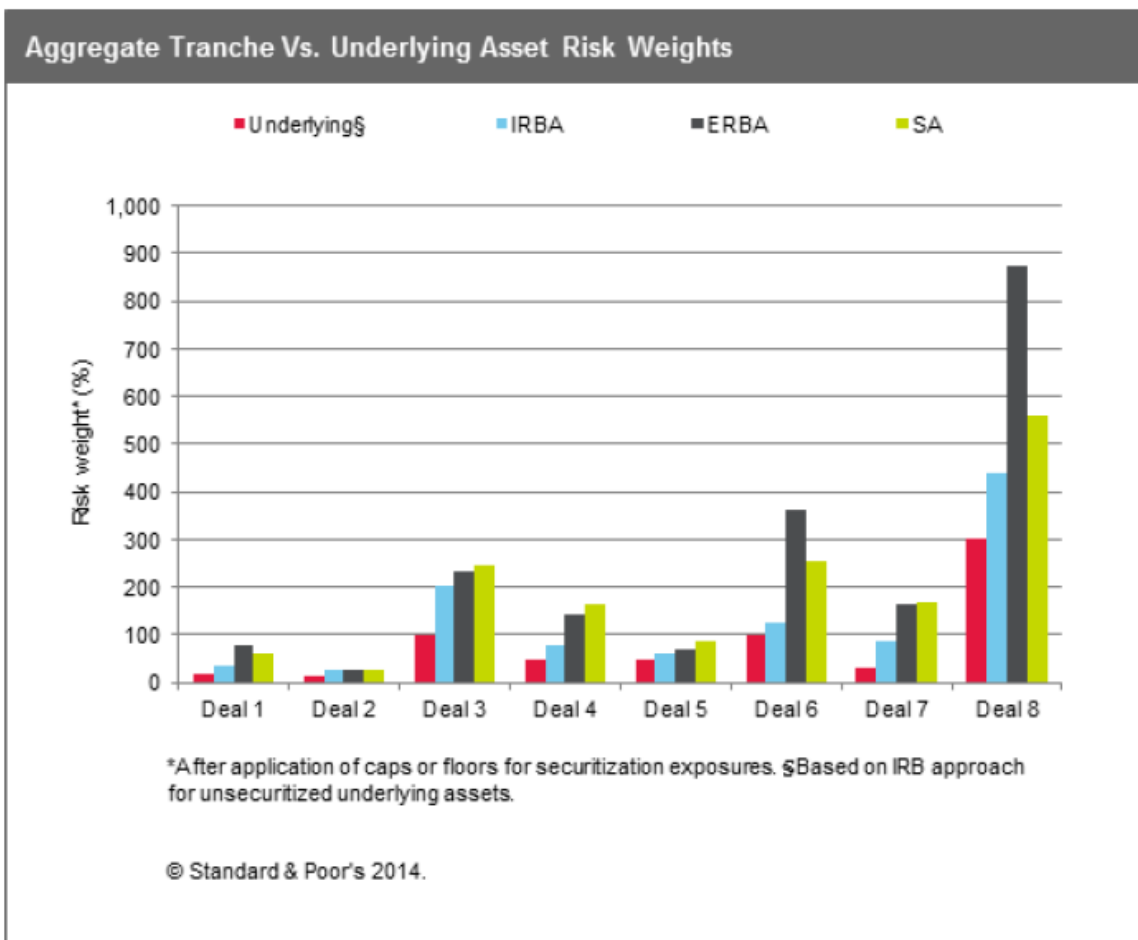


Even for the sectors that saw poor performance, one could argue that the lessons learnt pertain to the assessment of the credit risk characteristics in the underlying asset pools, rather than inherent weaknesses in the securitization process or transaction structures. Moreover, we have subsequently updated our structured finance ratings criteria in many areas to reflect experiences gained from the crisis, and we believe that ratings performance would be significantly more robust if the same kind of stress event were to reoccur.

Another way to consider the appropriateness of the proposed securitization capital charges is by referring to the equivalent capital charges on the underlying collateral pools. Some market participants have argued that the aggregate capital charge for all of the tranches of a securitization should be identical to—or at least close to—the capital charge for holding the entire underlying pool of untranched exposures. However, the December 2013 Consultation Paper explicitly rejects a premise of "capital neutrality", because "securitisations have a wide range of structural features that do not exist for banks holding the underlying pool outright and that are impossible to capture in models," and some "capital surcharge" is therefore required to cover model risk.

The reformulation and simplification of the formula-based approaches in the December 2013 Consultation Paper help to significantly clarify the scale of the capital surcharge being applied, in our view, through the so-called "p" parameter in the IRBA and the SA formulae. However, we note that capital charges for securitization exposures under the proposals often remain many multiples of the equivalent capital charges on the underlying collateral pools.

**Chart 4**



***Securitization capital charges under the ERBA appear to be miscalibrated***

In our comments on the December 2012 Consultation Paper we questioned the calibration of that proposal's calculation approach that was based on external ratings—the Revised Ratings-Based Approach (RRBA)—which in our analysis generally appeared to lead to much higher capital charges than several of the other approaches.

Based on our analysis of the revised proposals, we believe that the remaining ERBA also leads to unduly high capital charges.

Across our sample of rated securitization tranches, the ERBA results in capital charges (after applying any caps and floors) that are on average more than 50% higher than those under the SA, and an average multiple of six times higher than those under the IRBA (with this multiple ranging from 0.8 to over 50 across our sample). In our sample of rated tranches, the ERBA resulted in the highest or equal-highest capital charge among all of the various proposed approaches in more than 60% of cases.

This result strikes us as counterintuitive. Given that the ERBA ranks ahead of the SA in the proposed hierarchy, it means that—in jurisdictions where banks may use external ratings for this purpose—banks would often be required to take a higher capital charge by applying the ERBA if an external or inferred rating is available, than if no rating were available and they applied the SA.

We note that, if ERBA capital charges are often higher than SA capital charges, this may incentivize originators not to maintain external ratings on their securitizations—and bank investors not to demand them—at least based on regulatory capital considerations. We believe this would be a detrimental unintended consequence of the proposed calibration, as external ratings have a significant role to play in market transparency and as a tool to help market participants assess credit risk.

While we appreciate the Committee's aim of mitigating mechanistic reliance on external ratings, we do not believe policymakers should cast external ratings as an inferior means of assessing creditworthiness and—in this context—appropriate capital charges. In fact, as noted above, external ratings generally take into account many more risk factors (e.g., legal risk and operational risk) than are captured by the alternative proposed formula-based approaches, and we continue to believe they have a role to play in risk assessment.

***The frequent application of caps may undermine risk sensitivity***

The proposal includes provisions to limit the capital charges on securitization exposures where the various calculation approaches would otherwise lead to unduly high or low results.

The December 2012 Consultation Paper proposed extending the "overall cap" for IRB banks from the existing securitization framework to all originator and sponsor banks, helping to reduce inconsistencies in capital treatment between different institutions, in our view. However, it was unclear to us why this argument should not apply more broadly to all banks, e.g. including investors, rather than just originators and sponsors.

Some market participants have interpreted the revised proposals as expanding the "overall cap" to all banks. However, it is unclear to us whether that is the Committee's intention. The December 2013 Consultation Paper states that "the Committee proposes that the overall cap be applicable regardless of the approach that is applied...", but does not make clear whether the cap is limited by the role of the institution in question.

In addition, for senior securitization exposures, the revised proposals continue to include a risk weight cap that limits any senior exposure's risk weight to the average risk weight that would apply to the underlying assets.

In our comments on the December 2012 Consultation Paper we noted that, according to our analysis, far from being an exception, the proposed caps would likely have been triggered often, especially in cases where individual banks held a significant portion of the transaction. As the revisions in the December 2013 Consultation Paper have generally lowered the proposed capital charges for more senior tranches relative to the first proposal, we find that these caps would now generally determine final capital charges less frequently.

It is straightforward to simulate the effects of the proposed risk weight cap on senior securitization exposures. However, the effect of the proposed "overall cap" on capital charges may depend on whether the bank in question is an investor or an originator, and how large a portion of the transaction they are exposed to. In our analysis, we consider situations in which a bank holds the entire tranche of the securitization in question, but none of the other tranches. This approach would also apply if the Committee chooses to adopt an approach it is considering to allow a pro rata calculation of the maximum capital requirement in the "overall cap" rule. We believe such a pro rata calculation would make sense: For banks that are exposed to, say, a 10% share of a given tranche, losses are by definition capped at 10% of whatever losses the whole tranche ultimately accrues.

Under the assumptions above, about 30% of the securitization exposures in our sample would have their capital charge capped when using the ERBA, compared with 50% under the previously-proposed RRBA. The same applies to about 30% under the SA—similar to the proportion under the previously-proposed SSFA. Under our calculations for the IRBA, we find that about 15% of the exposures would see their capital charge capped.

We note that in the revised proposals, the Committee has reduced the risk weight floor to 15% from 20% previously. In our analysis, we see 30% of the tranches in our sample having their risk weights floored under the IRBA, with 10% of tranches—mostly senior ones—having risk weights floored under the SA.

While cap and floor mechanisms would therefore determine capital requirements less frequently than under the initial proposals, according to our analysis, we still believe that their relatively widespread application could undermine the risk sensitivity of the various calculation approaches.

## Appendix 2

Tables 1 to 8 provide details of the sample securitization exposures for which S&P calculated indicative risk weights and capital charges.

Table 1

U.K. Prime RMBS 1											
Class	Rating	Attachment point (%)	Thickness (%)	Maturity (years)	Uncapped risk weights (%)			Capped risk weights (%)			
					IRBA	ERBA	SA	IRBA	ERBA	SA	
A	AAA	34	66	2.2	0	18	1	15	18	15	
B	AA-	25	9	4.9	0	135	25	15	136	25	
C	A	17	8	5.0	0	174	106	15	174	106	
D	BBB	6	10	5.0	29	287	553	29	192	192	
Reserve	NR	0	6	5.0	703	1,250	1,248	323	323	323	
Overall					47	145	147	36	78	61	

Notes: Average IRB risk weight assumed for underlying portfolio = 20%; 90+ day arrears = 7%. NR--Not rated.

Table 2

U.K. Prime RMBS 2										
Class	Rating	Attachment point (%)	Thickness (%)	Maturity (years)	Uncapped risk weights (%)			Capped risk weights (%)		
					IRBA	ERBA	SA	IRBA	ERBA	SA
A	AAA	21	79	4.2	0	23	1	15	15	15
B	AA	20	1	5.0	0	129	13	15	129	15
Support	NR	0	20	5.0	179	1,250	458	76	76	76
Overall					35	266	91	27	28	27

Notes: Average IRB risk weight assumed for underlying portfolio = 15%; 90+ day arrears = 2%. NR--Not rated.

Table 3

U.K. Nonconforming RMBS										
Class	Rating	Attachment point (%)	Thickness (%)	Maturity (years)	Uncapped risk weights (%)			Capped risk weights (%)		
					IRBA	ERBA	SA	IRBA	ERBA	SA
A	AA	25	75	5.0	11	50	61	15	50	61
B	B	8	17	5.0	564	875	851	564	601	601
C	CCC	2	6	5.0	1,250	1,170	1,250	1,250	1,170	1,250
Reserve	NR	0	2	5.0	1,250	1,250	1,250	1,250	1,250	1,250
Overall					202	278	287	205	232	245

Notes: Average IRB risk weight assumed for underlying portfolio = 100%; 90+ day arrears = 18%. NR--Not rated.

Table 4

**Spanish RMBS**

Class	Rating	Attachment point (%)	Thickness (%)	Maturity (years)	Uncapped risk weights (%)			Capped risk weights (%)		
					IRBA	ERBA	SA	IRBA	ERBA	SA
A	A-	17	83	5.0	2	90	64	15	50	50
B	BB+	11	7	5.0	158	551	791	158	551	762
C	BB	9	2	5.0	364	755	1,198	364	755	1,197
Reserve	NR	0	9	5.0	992	1,250	1,250	564	564	564
Overall					107	236	239	80	142	165

Notes: Average IRB risk weight assumed for underlying portfolio = 50%; 90+ day arrears = 14%. NR--Not rated.

Table 5

**U.K. Credit Card ABS**

Class	Rating	Attachment point (%)	Thickness (%)	Maturity (years)	Uncapped risk weights (%)			Capped risk weights (%)		
					IRBA	ERBA	SA	IRBA	ERBA	SA
A	AAA	15	85	5.0	15	25	46	15	25	46
B	NR	0	15	5.0	777	1,250	1,046	338	338	338
Overall					128	206	194	63	71	89

Notes: Average IRB risk weight assumed for underlying portfolio = 50%; 90+ day arrears = 4%. NR--Not rated.

Table 6

**European CLO**

Class	Rating	Attachment point (%)	Thickness (%)	Maturity (years)	Uncapped risk weights (%)			Capped risk weights (%)		
					IRBA	ERBA	SA	IRBA	ERBA	SA
A	AA-	44	56	5.0	0	55	26	15	55	26
B	BBB	33	11	5.0	2	286	178	15	286	178
C	BB-	26	8	5.0	11	804	352	15	804	353
D	CCC-	18	8	5.0	64	1,151	642	64	1,151	642
E	CC	14	4	5.0	230	1,197	1,016	230	1,197	1,016
F	NR	0	14	5.0	1,030	1,250	1,249	738	738	738
Overall					155	434	324	126	364	254

Notes: Average IRB risk weight assumed for underlying portfolio = 100%; 90+ day arrears = 3%. NR--Not rated.

Table 7

**U.S. Prime Jumbo RMBS**

Class	Rating	Attachment point (%)	Thickness (%)	Maturity (years)	Uncapped risk weights (%)			Capped risk weights (%)		
					IRBA	ERBA	SA	IRBA	ERBA	SA
A	BBB+	7	14	3.7	34	99	586	30	30	30
B	BB-	6	47	3.8	20	440	232	20	64	64
C	BB-	6	30	3.7	30	579	357	30	99	99
D	B-	6	1	3.7	292	1,118	1,250	292	1,118	1,250
E	CCC-	4	1	3.8	473	1,232	1,250	473	1,232	1,250
F	CCC-	4	1	3.7	472	1,232	1,250	472	1,232	1,250
G	NR	2	2	3.8	942	1,250	1,250	942	1,250	1,250
H	NR	1	1	3.8	1,250	1,250	1,250	1,250	1,250	1,250
I	NR	0	1	3.8	1,250	1,250	1,250	1,250	1,250	1,250
J	NR	0	0	3.8	1,250	1,250	1,250	1,250	1,250	1,250
Overall					87	498	404	86	165	167

Notes: Average IRB risk weight assumed for underlying portfolio = 30%; 90+ day arrears = 9%. NR--Not rated.

Table 8

U.S. Subprime RMBS											
Class	Rating	Attachment point (%)	Thickness (%)	Maturity (years)	Uncapped risk weights (%)			Capped risk weights (%)			SA
					IRBA	ERBA	SA	IRBA	ERBA	SA	
A	AA+	95	5	1.0	0	15	47	15	15	47	
B	B	63	32	2.2	1	717	113	15	717	113	
C	D	39	25	5.0	131	943	379	131	943	379	
D	D	27	11	5.0	573	1,109	802	573	1,109	802	
E	D	8	19	5.0	1,220	1,007	1,221	1,220	1,007	1,221	
F	D	0	8	5.0	1,250	1,151	1,250	1,250	1,151	1,250	
Overall					434	872	558	439	872	558	

Notes: Average IRB risk weight assumed for underlying portfolio = 300%; 90+ day arrears = 42%. NR--Not rated.