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

baselcommittee@bis.org

Dear Sir/Madam

Revisions to the Basel Securitisation Framework

The Australian Securitisation Forum (the "AuSF") is pleased to have the opportunity to provide comments on the consultative document entitled "Revisions to the Basel Securitisation Framework" issued by the Basel Committee on Banking Supervision on 18 December 2012 (the "consultative document").

This submission is made by the AuSF through a working group of its regulatory and prudential subcommittee. The AuSF was formed in 1989 and is the peak industry body representing the Australian securitisation and covered bonds markets. A primary role of the AuSF is to facilitate the development of industry views and to represent those to policy makers and regulators. The AuSF supports the enhancement of market standards and practices, delivers educational workshops to build the professional standards of industry participants and promotes the Australian securitisation and covered bond markets to local and global stakeholders.

Attached to this letter is a paper outlining our comments on the matters raised in the consultative document that are of significance to the Australian securitisation industry. We would be pleased to discuss the views contained in the attached document and suggest this could be done by teleconference at a time convenient to your working group. Please contact me if you have questions on our submission or require additional information.

Yours sincerely

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

Chris Dalton

This submission is made by the Australian Securitisation Forum (the “AuSF”).

Abbreviated terms and definitions are set out in the Glossary at the end of the submission.

1. Summary

Securitisation has been and is a useful funding tool for banks and corporates to raise secured financing without reliance on central bank funding schemes. The AuSF’s concern is that the proposals of the Basel Committee will stifle the industry and increase costs.

The AuSF believes that the consultative paper fails to recognise that the industry has already taken action to address significant issues of the securitisation industry including revised ratings agency methodologies and the introduction of CRD4 and ECB regulations.

We request that the Committee allow enough time to conduct thorough analysis to avoid undue conservatism that may adversely impact the securitisation market and wider global economy.

In several places in the consultative document, the Committee has referred to the possibility of regulatory arbitrage across jurisdictions. The consultative document is proposing a complex set of regulations. With complexity comes the greater possibility of regulatory arbitrage. The AuSF urges the Committee to ensure that, as far as possible, the regulations are globally harmonised to minimise the possibility of regulatory arbitrage.

Section 11 sets out a summary of the AuSF’s recommendations.

2. Committee’s objectives

The objectives set out by the Committee in the consultative document are as follows:

1. to make capital requirements more prudent and risk-sensitive;
2. to mitigate mechanistic reliance on external credit ratings; and
3. to reduce current cliff effects in capital requirements

The AuSF supports the Committee’s objectives and makes the following observations.

Objective 1

The AuSF’s view is that the proposed approaches could make capital requirements less risk sensitive. This is further developed in section 4 below.

Making capital requirements higher comes at a cost and it is not clear that this is consistent with making the capital requirements more prudent. The AuSF’s view is that the cost of increasing the capital requirements as proposed far outweighs the benefit. In part, this is because the proposed capital requirements are inconsistent with a long time series of securitisation experience. The proposed requirements appear to be largely based on outlier asset classes such as CDOs, which were not representative of the performance of longer-established traditional asset classes. A preferable approach is to apply additional capital to those asset classes which

have performed poorly or which have experienced problems in the underlying assets leading to unreliable ratings. This would not apply where alterations have been made to the rating methodologies which increase the reliability of ratings.

Objective 2

The second objective is to reduce mechanistic reliance on external ratings. This was an issue for some exposures in some banks, particularly leading up to the financial crisis. However, whilst the application of an external rating may be mechanistic, the rating process itself is not. Instead the Committee is proposing a primary mechanistic reliance on formulae, particularly the MSFA. The AuSF believes this introduces a significant risk.

As set out in section 4, the MSFA cannot capture the subtleties and protections built into many securitisation transactions. Section 4 also sets out the AuSF's views on reliance on ratings. The AuSF suggests that alternatives such as an increased use of internal assessments or increased supervision in the use of external ratings are preferable.

Objective 3

The cliff effect was observed when AAA ratings of certain asset classes in certain jurisdictions suddenly fell below investment grade, thus dramatically increasing the capital requirements associated with securitisations of those asset classes. The AuSF's view is that this was not a problem with the existing capital requirements per se, but a problem with the ratings for specific asset classes or transactions in particular jurisdictions. Most asset classes did not suffer significant falls in ratings. As an example, Australian RMBS ratings have been very stable for many years. AAA tranches have only been downgraded (in a very small number of cases) due to credit dependencies on mortgage insurers and some swap or collateral counterparty downgrades, not because of collateral performance. The rating process is a dynamic one and the rating agencies have altered their models for those asset classes that experienced rating volatility.

3. Excessive capital requirements

The AuSF's view is that the proposed capital requirements do not reflect the credit experience of the securitisation market, nor are they reasonable in the context of the underlying assets¹.

3.1. Default experience

With the benefit of hindsight, Australia superficially seemed to be immune from the dislocation in world financial markets, neither entering recession nor having any regulated financial institution fail. However, it was a time of severe stress for the financial industry. The Australian Government guaranteed regulated entities (ADIs) deposits and senior debt issuance, and invested in securitisation product to provide support to the securitisation market. Many mortgage originators ceased new originations.

Australian prime RMBS performed with no losses or charge-offs on any rated note, prior to, during and after the global financial crisis². Only one sub-prime note rated by S&P experienced

¹ The mathematics underlying the MSFA are difficult to test without extensive portfolios and modelling, but given that Working Paper 23 states that the RRBA has been calibrated to match the MSFA, the RRBA is has been used for the purposes of examples in this section.

charge-offs and that note was rated 'B' at inception (a rating which would attract a 1,250% risk weight under the current RBA approach).

3.2. Appropriate risk weights based on global default experience

Australia's experience was exemplary, but as noted, it 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, S&P's five year default rate study ending in 2011 for Europe³ shows a default rate for exposures with an initial rating of AAA as 0.8%. This includes CDOs and other structured credit, which bore the brunt of the downgrades. The default rate for all RMBS (not just AAAs) was 0.1%⁴.

A 58% risk weight for a AAA exposure implies a default rate of 4.6%, far beyond the default experience of most asset classes. 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.

3.3. Capital held on balance sheet

The AuSF supports the principle of conservation of capital; 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 risk weights materially breach this principle.

Using Australian mortgages as an example, the four largest Australian banks (which are all advanced IRB banks) hold between 13% and 20% average risk weights for their mortgage portfolios⁵. If the banks were to securitise a portfolio of mortgage loans, and tranche them according to a typical Australian RMBS structure, the RRBA risk weight is 58% for a AAA tranche. Therefore, after structuring and credit support, capital held on the much lower risk AAA piece is 3-4 times more than if the assets were held on balance sheet. The total capital under the RRBA is over 6 times the capital assuming no securitisation, as shown in the example below of a typical transaction.⁶

² Standard & Poor's, *An Overview of Australia's Housing Market and Residential Mortgage-Backed Securities*, 27 August 2012, page 45.

³ Standard & Poor's, *Five Years On, The European Structured Finance Cumulative Default Rate Is Only 1.1%*, 23 August 2012

⁴ A 0.1% default rate equates to 0.9% equivalent risk weight. A 0.8% default rate equates to a 10% risk weight.

⁵ Australia and New Zealand Banking Group September 2012 Pillar 3 report page 43; Commonwealth Bank of Australia June 2012 Pillar 3 report pages 11 & 46; National Australia Bank September 2012 Pillar 3 report page 18; Westpac Banking Corporation September 2012 Pillar 3 report page 43.

⁶ This example assumes a 15% on-balance sheet risk weight, that all tranches are subject to the 5 year maximum maturity (see section 10) and the Class A tranches are senior (A1 to A3 tranches being sequential time tranches). If the A2 and A3 tranches are deemed non-senior, the multiple is over 7 times.

Tranche	Rating	Weighted Av Life	\$	RRBA
A1	AAA	2	200	58%
A2	AAA	3	211	58%
A3	AAA	5	49	58%
B	AA-	6	30	294%
C	N.R.	10	10	1250%
			500	96%

On-balance sheet risk weight 15%
RRBA as a multiple of on-balance sheet risk weight 6.4

If this approach is adopted, there will be significant flow-on effects which are outlined in section 5.

3.4. Capital caps

Pages 32 and 33 of the consultative document refer to capping the amount of capital for originators and applying the look-through approach for senior non-rated exposures to cap the amount of capital to the underlying exposures under the IRB framework. The AuSF supports caps as the logical extension of the principle of conservation of capital stated above. In practice however, under the proposal, these caps will apply in limited circumstances in unrated transactions when the investor holds most of the exposures.

The AuSF would support the extension of these caps to all exposures, whether rated or otherwise, and whether or not the bank is the originator of the underlying assets.

3.5. Seniority

Subject to our comments in section 3, the AuSF supports a mechanism for thin non-senior tranches to have a higher capital requirement than senior tranches on the basis that the LGD increases in inverse proportion to the thickness of the tranche. The AuSF considers there should be an exception where the senior investor also contiguously holds non-senior tranches (other than the most junior tranche). If that were the case, the two or more contiguous tranches should be treated as a single senior tranche for capital purposes.

3.6. 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 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.

3.7. Conclusion and AuSF view

Capital has been set 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.

4. Reliance on external ratings

The Committee's first stated objective is for risk-sensitive capital requirements. In order that capital requirements be risk-sensitive, an assessment needs to be made of the risk. This assessment can be made:

- according to some fixed classification (for example, Basel I);
- internally by the organisation with the exposure (for example, under the IAA);
- externally by another organisation (for example, a rating agency under the RRBA);
- using some inputs that are assessed, others that are part of the structure and a formula (MSFA); or
- some blend of the above.

The AuSF's view is that risk assessments should have regard to the underlying risk characteristics of the assets, the credit support provided, the particular structural features of the transaction (including features such as insurance, excess spread, spread traps, amortisation triggers etc) and the quality of the underwriting and servicing. Risk assessments should make use of full cash-flow models with stress scenarios based on accurate historical data which then provide a probabilistic assessment of the risk of loss (including probability of default, exposure at default and loss given default) in relation to particular tranches. This method is based on easily auditable historical data, stress factors and assumptions.

The AuSF is of the view that formula-driven approaches do not provide sufficiently risk-sensitive capital. This is because of the necessary simplifications and assumptions that are made to the transaction features in order to make a formula solution tractable. In addition, a significant risk is introduced with a complex derivation of a formula. Working Paper 22 sets out the foundations of the MSFA which requires significant mathematical ability and research into the academic literature. It suffers from the same issues that very technical products sold before the financial crisis also suffered.⁷ The following paragraph sums it up well.

78. Lastly, it is worth emphasising that the MSFA framework developed herein does not address a number of well-known shortcomings of SFA and IRB framework more generally. The single systematic risk-factor model embedded in the SFA and IRB frameworks remains a key postulate within the MSFA, and is in fact critical to affording tractable solutions or approximations to key inputs. Nevertheless, the assumption is simplistic and restrictive, and may not adequately represent the credit risks within pools containing concentrations of borrowers from multiple sectors, geographic regions, etc. As with the SFA, the MSFA also assumes a highly simplistic structure for how pool losses are allocated among tranches. Many complex structures of the form seen prior to the financial crisis cannot be readily mapped into the simplified MSFA template. Other MSFA shortcomings include reliance on the questionable assumptions that risk factors are normally distributed with fixed variances over time and that the market price of risk is stable over time. While the proposed MSFA incorporates assumptions and prudential add-ons to offset some potential modelling weaknesses, these may only partially cover the full range of model risks.⁸

⁷ We also note that Working Paper 22 uses the words “assume” or “assumption” 54 times and that the method is described as intractable in at least two places, utilising approximations.

⁸ Basel Committee on Banking Supervision, *Working Paper 22 – Foundations of the Proposed Modified Supervisory Formula Approach*, January 2013, page 31.

5. 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.

1. As noted in the example in section 3.3, the capital required to hold securitisation tranches is at least 6 times that to hold assets on balance sheet for a less risky position. Therefore we would expect bank 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.
2. In theory, spreads could rise to compensate banks for the extra capital. However, the proposed risk weight of 58%⁹ for a AAA tranche is more than 8 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.
3. 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. As a consequence, competition and innovation in the home lending market decreased significantly and interest rate margins increased. 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.

6. Conflict with other Basel Committee, IOSCO and FSB objectives

Basel Committee and HQLA

The revisions to the Basel Committee's Liquidity Coverage Ratio issued on 7 January 2013, requires banks to hold an adequate stock of unencumbered high-quality liquid assets (HQLA) that can be converted into cash easily and immediately in private markets to meet its liquidity needs for a 30 calendar day liquidity stress scenario. The revisions allowed certain RMBS to be included in HQLA portfolios. The effect of the proposals in the consultative document would be materially to reduce the stock of RMBS meeting the HQLA criteria and thus seems to contradict directly the intention of the Committee in revising the HQLA asset definition.

FSB and IOSCO

The following statement comes from IOSCO report "Global Developments in Securitisation Regulation".¹⁰

⁹ We have chosen this risk weight as almost all Australian RMBS are pass-through with a final maturity of around 30 years and so will attract the maximum 5 year maturity under the proposal.

¹⁰ International Organization of Securities Commissions (IOSCO), *Global Developments in Securitisation Regulation*, 16 November 2012

“Securitisation, when functioning properly, is a valuable financing technique contributing to economic growth and an efficient means of diversifying risk. Securitisation played this role in the past. As also acknowledged by the FSB SRC in its request, IOSCO believes that these benefits of securitisation remain unchanged.”

As has been stated previously, the proposed capital requirements will have the effect of substantially lessening the demand and supply of securitised product and thus seem to contradict IOSCO and the FSB’s views on securitisation.

7. Hierarchy

The AuSF prefers Alternative A to Alternative B, but with some suggested changes as set out below. Of course, as stated in section 3, this must be in combination with reasonable capital requirements.

The following revised Alternative A hierarchy is suggested for all exposures except resecuritisation:

1. IAA (but not confined to ABCP);
2. RRBA;
3. MSFA;
4. SSFA;
5. BCRA.

In each case, the risk weights would be subject to a cap being the weighted average of the risk weights of the underlying exposures, calculated on an IRB basis, if possible, or an SA basis.

IAA

For reasons previously set out in sections 2 and 4, the AuSF is of the view that a transaction-by-transaction credit assessment is the best approach in determining a risk assessment which can then be translated to a standardised measure such as a rating agency equivalent. On that basis, the AuSF is of the view that the Internal Assessment Approach should be at the top of the hierarchy. Each eligible bank would map its internal assessment against a standardised table and apply the relevant risk weight.¹¹

If a transaction is rated and eligible to be assessed under the IAA, the bank would take the lower of the IAA and RRBA risk weights.

RRBA

There will be various banks which do not use the IAA and asset classes in which banks that do use the IAA, are not accredited. In that case, the AuSF believes the next option in the hierarchy

¹¹ Under Australian Prudential Standard 120, the Australian standard governing securitisation, Australian banks can be accredited by its regulator to apply the IAA to approved asset classes, even if the exposure not an ABCP one.

should be the RRBA. As with the IAA, the risk weight would be a function of the rating and seniority¹². We have provided comments on the level of risk weights in section 3.

The AuSF does not support the proposal for two ratings to be required to use the RRBA. The AuSF appreciates that the Committee is trying to minimise rating arbitrage, but in the experience of the members of the AuSF, different rating agencies providing materially different ratings occurs very rarely. The AuSF's view is that the cost of requiring two ratings for all transactions outweighs the small number of examples where the ratings would differ between agencies.

MSFA

We have noted several deficiencies in the MSFA in the sections above. However, the main deficiency is that, in most cases, banks can only use the MSFA for their own assets¹³. Since banks do not generally hold tranches of their own securitisations other than for liquidity reasons¹⁴, there appears to be little application for the MSFA. Although the AuSF believes the application of the MSFA will be limited, it is possible that there are situations where it could be used for an unrated transaction and the AuSF therefore suggests that it be included in the hierarchy, but at a lower position than the consultative document recommends.

SSFA

The AuSF proposes that the SSFA be beneath the RRBA, rather than a jurisdictional alternative. This will minimise the level of disparity in approaches between jurisdictions.

The SSFA does not require the K_{IRB} , only delinquencies, and is thus more practical to calculate. The AuSF suggests that ρ be set at 0.5 to match the equivalent in the United States. The AuSF notes that Moody's¹⁵ has calibrated ρ and suggests that even if it is set at 0.5, it is too conservative. On that basis, the Committee's suggestion that ρ be set at 1.5 looks overly conservative.

BCRA

As with the SSFA, the BCRA does not require K_{IRB} . The AuSF is of the view that the increase in risk weight for detachment points less than 100% is sufficient without the need for doubling.

¹² In relation to maturity, see section 10 below.

¹³ Due to the requirement to monitor K_{IRB} continuously.

¹⁴ And in most cases in Australia, the underlying assets would be risk-weighted as if they were on-balance sheet

¹⁵ Moody's, *CLOs and the SSFA*, December 2012

8. Resecuritisation

The AuSF recommends that the appropriate test for application of resecuritisation capital should be based on substance rather than legal form. In particular, the definition of resecuritisation should be modified to exclude transactions that are not fundamentally resecuritisations. For example:

- The investment of temporary cash in securitised paper, such as ABCP up to a limited proportion of any given transaction's total assets, say 5%, should not trigger the classification of a transaction as a resecuritisation.
- The use of a double trust structure (which is common in ABCP transactions) where there is no tranching or credit modification should not cause the transaction to be classified as a resecuritisation.

9. Transition/Grandfathering

The AuSF notes that transition has sometimes been granted only to the date of the announcement of the initial proposals on the basis that notice has effectively been given as of that date. However, at the date any proposal is initially published, there is considerable uncertainty as to the final outcome, which could be months or years in the modification and implementation. The industry is therefore uncertain how to structure transactions and whether they should be undertaken at all. If the Committee gave certainty as to how transitional relief would be undertaken, much of the uncertainty would be removed.

Therefore, 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 transitional relief is not granted, significant capital volatility could occur, including the cliff effects that the Committee seeks to avoid under the proposals.

10. 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 IAA or RRBA 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 IAA or RRBA.
2. The consultation document 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 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 3, 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.

11. Summary of AuSF recommendations

Recommendation	Section
Capital requirements should reflect actual or reasonable potential default experience	3.2
Apply the principle of conservation of capital (capital caps)	3.3 and 3.4
Alternative A should be adopted for the hierarchy of approaches, subject to the order set out in section 7	7
Apply greater capital to outliers unless ratings amended	2
Apply greater capital to new asset classes or structures until they have demonstrated a track record through the economic cycle	3.2
Non-senior tranches should have a higher capital treatment unless a senior investor also contiguously holds non-senior tranches (other than the most junior tranche)	3.5
If IAA is used and the exposure is rated, the higher risk weight would be used	7
The AuSF does not support the proposal for two ratings to be required to used the RRBA	7
ρ should be set to 0.5 in the SSFA	7
The test of resecuritisation should be based on substance, not form	8
Transitional relief should be granted for all transactions from the date of implementation of the new standards	9
Maturity should not be included in the RRBA	10
Maturity should take account of repayments and reasonable prepayments	10

Glossary

ABCP	Asset-backed commercial paper
ADI	Authorised Deposit-taking Institutions (Australian regulated banks, building societies and credit unions)
AuSF	Australian Securitisation Forum
BCBS (or the Committee)	Basel Committee on Banking Supervision
BCRA	Backstop concentration ratio
Consultative document or the proposals	Consultative document on Revisions to the Basel Securitisation Framework issued by the Basel Committee on Banking Supervision
CRK_{IRB}	Concentration ratio based on K_{IRB}
IAA	Internal assessment approach
IRB	Internal ratings-based approach
K_{IRB}	IRB capital for the underlying pool of securitised assets
K_{SA}	SA capital for the underlying pool of securitised assets
LGD	Loss given default
MSFA	Modified SFA (under the consultative document)
PD	Probability of default
RBA	Ratings-based approach
RMBS	Residential mortgage-backed securities
RRBA	Revised RBA (under the consultative document)
SA	Standardised approach
SFA	Supervisory Formula Approach
SSFA	Simplified SFA (under the consultative document)