

Basel Committee on Banking Supervision
via e-mail: baselcommittee@bis.org

Date 15 March 2013
Reference BR1840

Regards: NVB response to BCBS 236 - Revisions to the Basel Securitisation Framework

Dear Sir, Madam,

On behalf of the Dutch Banking Association¹ (NVB), I would like to thank you for giving us the opportunity to react to Consultation Paper BCBS 236 "*Revisions to the Basel Securitisation Framework*". Investor confidence in securitisation is gradually restoring after a period where it became apparent that certain intrinsically risky asset classes - rather than securitisation itself - was a fundamental risk driver underlying the financial crisis. Public perception of securitisation has not kept pace with this restoration of trust. It is important to maintain the positive dynamics in investors' trust in securitisation instruments, ensuring the securitisation market can continue to fund real economy lending. We appreciate the Basel Committee has reviewed the current securitisation framework and formulated proposals for its improvement. The areas where changes were proposed relate to capital requirements, the reduction of cliff effects and a reduction of the reliance on external ratings. The introductory part of our response will cover the main points of attention, followed by the answers to the specific questions.

The lack of granularity in the chosen approach, and its impact on retail financing

The economic drivers that dictate asset performance vary greatly across asset classes and jurisdictions. A car loan cannot be compared to a mortgage loan, and the performance of loans in the same asset class is often closely linked to the state of the national economy. The framework proposed by the Basel Committee does not distinguish between any of the asset classes used for securitisation, nor does it take into account the different risk characteristics, or economic circumstances. Especially mortgages have different risk characteristics in comparison to other assets. These are caused by differences in legal frameworks (e.g. borrower recourse), differences in social security policies and the overall status of the national economy. Not distinguishing between asset classes, penalises assets with below average risk weights - most specifically retail loans - as the average risk weight of all asset classes used for securitisation is the proposed benchmark. Also, securitisation does not change the risk associated with the asset pool; the total risk weight prior and post securitisation should be comparable.

¹ The Dutch Banking Association (NVB) is the representative voice of the Dutch banking community with over 90 member firms, large and small, domestic and international, carrying out business in the Dutch market and overseas. The NVB strives towards a strong, healthy and internationally competitive banking industry in the Netherlands, whilst working towards wider single market aims in Europe.

To put it in statistical terms, it is doubtful if, in the sample space of all securitisations, the observations belong to one single set that has uniform statistical characteristics. Alternatively, multiple statistically significant subsets could exist. Full recourse residential mortgages, for instance, could be a subset. If multiple subsets exist, this should be reflected in the regulatory treatment.

The current proposal significantly increases risk weights for most retail portfolios and some corporate portfolio's². This especially impacts relatively low risk retail assets, where securitisation is often used for funding purposes. Increased risk weights, result in higher capital requirements, which increase the rate of return required by investors. If the required rate of return goes up, the spread to be paid by the issuer will also go up. When spreads increase, the cost of funding the asset pool increases. This will create an upward pressure on interest rates to be paid by the customer, decreasing the provision of credit to economically critical market segments, such as SMEs and retail consumers.

It is recommended, the Basel Committee investigate the underlying assumption that all securitisations act as one uniform statistical set. If the investigations confirm the existence of multiple sets, the current one-size-fits-all-approach should be revised. The number of subsets created should be kept to the minimum required to sufficiently increase the granularity of the framework, creating commensurate risk weights. If the granularity is increased, the MSFA would produce the most risk sensitive results. However, if the calibration is adjusted the SSFA would also produce better results than it currently does. Asset classes that could form distinct subsets are full recourse mortgages, SME loans and consumer loans (such as car loans). These assets have different risk characteristics, which are reflected in differences in the observed performance. By marginally increasing the complexity of the regulation, the results will create a closer link to the actual risks of the securitised assets. This would decrease the reliance of the framework on the risk weight cap, especially for retail based securitisations.

The calibration of the risk weights; sample stratification

Next to doubts about the granularity of the proposal, the data used by the Basel Committee appear to be improperly stratified, overemphasising risky assets. This effect becomes clearly visible, when comparing the average PD and LGD used by the Committee to real life examples.

Working paper 23³, states the assumed one year PD is equal to 4.729% and the LGD is 55%. The one year PD of Dutch SME securitisations lies in a range of 0.3% - 0.5%. The LGDs lie in a range of 15% and 25%. For mortgages, the average one year is expected to be even lower⁴.

Another example: under the proposed RRBA, a 5-year "AAA" rated senior tranche of a securitisation transaction, gets a risk weight of 58%. Comparing this risk weight to that of a corporate bond, a senior unsecured financial bond or even a covered bond (for which there is a special treatment in Europe), the risk weights would be roughly equivalent to "A-" for the corporate bond, "BBB-" for the senior unsecured financial bond or even "B-" for the covered bond, respectively. This clearly demonstrates the overestimation of risks in the current proposal.

² Mostly portfolio's that have been securitised for working capital purposes, such as trade receivables, equipment- and auto leases.

³ Working Paper 23 "The Proposed Revised Ratings-Based Approach" of January 2013, page 9 and page 10

⁴ Lifetime PDs of mortgages are 3% and therefore one year PDs can be assumed to be much lower. Average LGDs for mortgages are 30%. (Source = Fitch Residential Mortgage Briefing, Jan. 2013)

The stratification of the sample used for the final calibration of the framework should reflect the characteristics of the particular set, be it one set (as currently proposed) or multiple subsets. The QIS data could be helpful in this area. Following this approach will surely better align the currently proposed (very) high risk weights for senior tranches of retail based securitisations, to the economic reality. Doing so, would preserve the important role of securitisation as a funding tool for retail credit.

Regulatory changes already enforced

Since the start of the global financial crisis, the regulatory treatment of securitisations has already been significantly tightened, due to a number of changes. The most important changes are the increase of the risk weights of re-securitisations, the requirement to maintain a net economic interest in the securitisation by the originator and increased transparency requirements. Also, rating agencies adapted their methodologies, and made them more stringent. All these changes are designed to address shortcomings that existed prior to the crisis and result in a more resilient regulatory framework. Given all the changes that are already enacted, it is questionable if the tough approach suggested by the Basel Committee is still warranted.

Financial Industry initiatives

The industry has developed a number of initiatives to better enable investors in securitisations to identify quality transactions by increasing transparency and reducing complexity. In Europe, the quality label "Prime Collateralised Securities" (PCS) has been launched. In the Netherlands, a standard has been developed for Dutch RMBS by the Dutch Securitisation Association⁵. More information is provided in the answer to question 3.

The application of the risk weight cap

Regardless of the aforementioned fundamental points, the Basel Committee built in a feature that ensures the risk weight of a senior tranche does not exceed the risk weight of the underlying asset pool; the risk weight cap. Unfortunately, the consultation paper does not specify how an investor can apply the rules to an underlying pool under the IRB framework. The text below contains an overview of the three approaches that could be adopted for the application of the cap. Although none of these proposals are flawless, option 2 will result in a balanced framework that produces commensurate risk weights across all major asset classes, whilst upholding the role of securitisation as a funding instrument. However, the preferred and suggested course of action is to perform a more fundamental review of the proposal, as previously discussed.

There are three theoretical options to apply the cap:

1. An investing IRB bank uses its own IRB model to calculate the risk weight cap.
2. An investing bank (either IRB or SA) uses the average risk weight of the asset pool, based on the IRB model of the originator.
3. An investing bank uses the standardised approach.

Ad 1 - Investing bank uses its own IRB model:

This solution can be achieved in two ways. First, the IRB bank could use its existing IRB models to manage the securitisation position. This approach can only produce correct risk weights if the securitised asset exactly matches the portfolio of the investing bank's IRB model. Given the specific nature of IRB models, such a situation is highly unlikely. Alternatively, a bank could develop an IRB model for the portfolio it invests in. In this situation, the investing bank will most likely not have the required historical data. This solution also consumes a considerable amount of resources from banks as well as from competent authorities.

⁵ Please see <http://www.dutchsecuritisation.nl/dutch-securitisation-standard> for more information

Ad 2 - Investing bank uses the average risk weight of the securitised assets:

Under this approach, the investing bank would use the average risk weight of the underlying pool, based on approved and validated IRB models of the issuing bank. As a consequence, the modelling challenges of the first approach are circumvented. However, this solution places a reliance on internal models of other banks, which might have been developed in jurisdictions outside of the control of the supervisor of the investing bank. It also increases interconnectedness, but it decreases the reliance on external ratings. Last but not least, this approach can only work if the regulatory community requires disclosure of the average risk weight of the underlying pool.

Ad 3 – Investing bank uses the standardised approach:

Using the SA risk weight is appealing for its simplicity and the preservation of the level playing field. However, as the SA is conservative by nature, this would result in substantially increased risk weights for investing banks. The increased risk weights will increase the cost of funding and will hinder the provision of credit to the economy, as was mentioned earlier.

Timelines

The timelines set by the Basel Committee were extremely challenging and the consultation period ended before the QIS submission date. Consequently, there is a risk that new insights surfaced after the consultation period expired. Such insights will not be reflected in this letter. Due to the delayed availability of the supporting documents and templates, banks had to delay their work on the QIS, which further reduced the time available for this consultation. Although an extension of the consultation period would have been welcome, we provided the best feedback possible within the limited time that was available. Considering the limitations, a second round of consultation would be appreciated.

Grandfathering

The current proposals do not distinguish between existing transactions and new securitisations. Many existing transactions will not have sufficient information available in the market to calculate the more complex methods that are proposed in the consultative document. The Basel Committee should set up a grandfathering scheme for such transactions.

The role of ABCP in trade financing

Asset Backed Commercial Paper conduits are used to securitise – and finance – trade financing transactions. Such instruments have exhibited strong performance over time, which is due to the revolving nature of the business and dynamic structures that adapt to asset performance. The proposals put forward by the Basel Committee ignore this performance, as the assumed maturities are significantly longer than the current business practice. A lower risk weighting should be allowed.

This concludes the main remarks. Please refer to the annex, for the responses to the various questions. Should you have any questions or remarks, please feel free to contact me at your convenience.

Kind regards,



Onno Steins
Advisor Prudential Regulation

Annex – Responses to the specific questions and other remarks

The answers provided to the individual questions should be regarded in the context of the more fundamental points discussed earlier. In our view, the stratification and calibration of the framework should be revisited, before fine tuning the proposal.

Question 1:

What additional costs and benefits of the two hierarchies should the Committee consider? Which hierarchy presents the greater benefits relative to its drawbacks? Which hierarchy would best address the shortcomings identified with the current framework, whilst meeting the Committee's objectives?

A: In our view, additional work needs to be done on the framework itself, before this question can be answered. Under the current proposal, securitisation will be hit hard under both hierarchies.

Notwithstanding this position, should no revisions be applied and one of the options had to be selected, then option A provides a better balance between benefits and costs, although an alternative option is preferred (see question 4). A major concern is that the suggested risk weights are excessively conservative given the performance of asset classes for which securitisation is still a viable financing source (and was a viable financing source throughout the crisis). This view is also based on the changes in criteria and the mandated measures for increased risk retention, due diligence, stress testing, etc. that have already been imposed since the crisis. The excellent track record of Dutch RMBS and corporate trade receivables should be noted in this context, and these securitisations are important for the healthy functioning of the Dutch and other economies.

There is a general concern regarding the MSFA. This is described below.

General on MSFA

The main issue regarding the MSFA, is that its use will not solve all the gaps in the current methodology for capital calculation. A general concern is the quality of K_{IRB} . For older securitisations, loan-by-loan data may not always be available for all securitised pools, and banks may lack the expertise to use such data to derive the PD, LGD and AVC for all pools of these securitisations.

Missing parameters MSFA

The Supervisory Formula does not capture all relevant risks. Our concern is that the calculation does not capture some of the most relevant parameters:

Item	Description
Short term maturities	Please see question 6
Flexible O/C levels	For strictly monitored deals this is an important risk mitigant. This is especially the case for quickly revolving assets, as O/C level can be adjusted on short notice to respond to changes in the market.
Clear requirements on information available for K_{IRB} estimation	This can be aligned with similar requirements for corporate and retail exposures.

Alternative A: benefits

A benefit of this alternative is that it is consistent. There are less possibilities for arbitrage than under Alternative B. However, there is some concern about the choice given to jurisdictions, as this could create significant differences regarding capital requirements for the same position. A benefit of the supervisory formula is that it gives some insight in the underlying risk parameters compared to the use of external ratings.

However, the MSFA does not capture all relevant risk parameters. We believe that the IAA should be preserved at the top of the hierarchy in addition to the MSFA, given that it has been in place for some time now, and it has a demonstrated track record.

Alternative A: costs

The costs of the new approach would be significant. This is related to IT investments, additional staffing and costs of gathering information.

Alternative B: benefits

Alternative B is useful in situations where securitisations are used as a funding instrument instead of capital relief. However the alternative is more vulnerable to arbitrage. The industry in Europe has made steps to improve the transparency and quality of transactions, that could be used in the regulation.

Alternative B: costs

The costs would increase in line with approach A.

Question 2:

As regards Alternative A, could both the revised RBA and the SSFA be accommodated without raising concerns about regulatory arbitrage or level playing field?

A: The main concern is that the approach will insufficiently distinguish between the better and lower quality securitisations. Cliff effects will still remain, although they are less than under the current approach. In Europe, it is expected that only one of both alternatives will be allowed. Regulatory arbitrage is therefore a concern outside the EU.

Question 3:

As regards Alternative B, which methods could a bank use to conclude that a securitisation exposure is of high-quality? Would the use of these methods likely result in a capital charge consistently related to credit risk across banks and countries? Would Alternative B produce material cliff effects as exposures deteriorate below high-quality?

A: Quality labels, such as PCS, and standardisation initiatives, such as the one developed for RMBS by the Dutch Securitisation Association, help investors select quality transactions. They will make finding the required information easier and more efficient for investors, wanting to analyse deals in a systematic way. In Germany, TSI has developed a similar standard for car loan securitisations. Next to these market initiatives, it is straightforward to determine whether a tranche is senior or not. This would be a logical starting point when considering the risk weight cap (or BCRA) for senior tranches. It would not suffer from cliff effects, should a securitisation exposure no longer be of high-quality.

The differences between the capital calculations under RRBA/IAA or MSFA/SSFA compared to the concentration ratio K_{IRB} are very significant. As a consequence, the determination of what is a high-quality securitisation will be one of the most significant drivers of capital requirements. Significant cliff effects are expected. The concentration ratio approach relies only on the detachment point for sizing the capital requirements and does not include credit support. This approach will overly penalise subordinated tranches.

Question 4:

Are there alternative hierarchies or revisions to the two proposed (or a combination of both) that the Committee should consider?

A: As mentioned earlier in the letter, a more fundamental review of the proposal is preferred. For a more detailed response, please refer to the answer provided by the EBF.

Question 5:

The Committee recognises that in some instances and in some jurisdictions, the requirement for two external ratings could be difficult to implement or could impose additional costs on banks. The Committee requests feedback on the relative merits of reducing idiosyncratic, rating agencies' modelling risk with the costs of using two ratings and/or whether exceptions to this treatment should be permitted.

A: In our view, a bank should still be allowed to apply RRBA when there is only one (inferred) rating, as the RRBA seems to capture multiple risk drivers. Some of the other methods (lower in the hierarchies) don't do this, or to a lesser extent. To account for the increasing exposure to rating agencies' model risk, the Committee could consider also making the RRBA dependent on the number of available (inferred) ratings. Given a certain rating level, the more (inferred) ratings are available for a tranche with that rating level. As the risk weight becomes lower, it should be compared to similar tranches with fewer (inferred) ratings. The Committee could introduce a second, more stringent table of revised RBA parameters for tranches with only one (inferred) rating. Legacy portfolios should - also given the amount of labour required in (re-)rating all the currently outstanding legacy securitisations - be exempted from this requirement.

Question 6:

Is the RBA appropriately calibrated and formulated? Should other risk drivers be incorporated?

A: At this point we do not believe it is, as was discussed at the beginning of our response. The calibration is too conservative.

Maturity

Certain products have short maturities. By comparison, for non-tranched purchased receivables deals, shorter maturities are allowed. It is proposed to allow shorter maturities under certain conditions and to adjust the risk weights in the RRBA accordingly.

The conditions to allow the use of shorter maturities should be consistent with the maturity conditions that can be found for purchased receivables. Furthermore, this approach should only be allowed in case of flexible O/C levels, taking into account these additional safety measures:

- There is a flexible O/C level, combined with strict monitoring;
- The assets are strictly monitored;
- Uncommitted or committed with sufficient restrictions.

Maturities up to 90 days should be allowed for certain asset classes. For the sake of consistency, the minimum risk weight for short maturity deals should be reduced to about 10%.

Question 7:

Is it appropriate to require that in order for the MSFA to be used the IRB approach should be applied for all underlying assets?

A: This is not appropriate. The prevalence of mixed pools may have been underestimated in the consultative paper. The MSFA should be available where the bank applies the IRB approach to the “predominant” share of exposures (as under Basel 2). For immaterial non IRB share of exposures, the use of a conservative proxy data should be authorised. At least the Basel Committee should provide a threshold for such mixed pools.

Question 8:

Is the MSFA appropriately calibrated and formulated? Does it incorporate the appropriate risk drivers? Is the calibration of tau and omega appropriate? If not, what evidence can respondents provide to support an alternative calibration?

A: The MSFA as a whole, as well as the calibration of tau and omega, is highly theoretical. It will be a challenge to make the parameters ‘precise’. The overall concern is not caused by tau and omega, but by the overall calibration of the MSFA.

Question 9:

Is it prudent to allow the use of the MSFA by banks making use of the foundation IRB approach (i.e. not calculating internal estimates of the underlying loans’ LGD)?

A: Based on the premise that foundation IRB (FIRB) is used as a transitional measure from the Standardised Approach to advanced IRB, there is no reason why this should not be allowed, especially since the FIRB LGDs are set at conservative levels.

Question 10:

Is the SSFA (particularly the constant term p) appropriately calibrated? Please provide justification and evidence, to the extent possible, for alternative appropriate levels of calibration?

A: As the P factor is fixed, it does not take into account the behaviour of the assets. Basing the P factor on historical data would make it more realistic. Also, the fixed value of P proposed, represents a stress scenario. Also refer to the answer to question 8.

Question 11:

Is the SSFA properly formulated or should other risk drivers, such as maturity, be incorporated?

A: The mitigating effect of over collateralisation and credit enhancement is not taken into account at all. In cases where K_A is equal to zero -which theoretically can occur for a securitisation of 0% risk weighted assets- the a-parameter cannot be determined. Also refer to the answer to question 8.

Question 12:

Has the BCRA been appropriately calibrated and formulated?

A: The BCRA appears to be penal in a lot of cases, which indicates it might not be appropriately calibrated. The parameter F could be dependent on the attachment point or the tranche thickness. Doubling the capital requirements for non-senior tranches might be a bit harsh. It also does not differentiate between non-senior tranches.

Question 13:

What factors should the Committee consider in weighing whether the F parameter should be set at 2 for senior as well as non-senior tranches to avoid arbitrage opportunities?

A: The F parameter should be made more specific to the quality of the underlying assets that are being securitised. We suggest specifying F parameters per asset class, as discussed earlier. This would create the possibility to come up with a treatment that better reflects the risks, especially for retail portfolios. For senior tranches only values smaller than one should apply. A value larger than one would be at odds with risk weight cap that is proposed for senior tranches on pages 32 and 33 of the consultative document.

Question 14:

How prevalent and material are securitisation exposures backed by mixed pools?

A: The use of mixed pools is not uncommon. They are an effective way to run-off small positions if credit support is sized appropriately.

Question 15:

Is the proposed treatment for mixed pools appropriate, or should another approach be employed?

A: No, a threshold should be introduced to reflect the current regulatory practice. With respect to a mix of securitisation and re-securitisation exposures, a defined and capped portion of securitisation tranches in an otherwise granular pool of exposures should not necessarily have a negative effect on the pool's performance, but it makes a difference whether the re-securitisation pool consists of junior or senior securitisation exposures, and what the quality of the underlying assets of those securitisation exposures is. Also, the definition of re-securitisation captures some ABCP exposures, such as credit enhancement for ABCP, whose rationale and performance are different from other re-securitisations. Under the current proposal, capital for ABCP falls under the BCRA and thus ignores the substantial credit enhancement that typically exists for these exposures.

Question 16:

Is the definition of maturity appropriate, in light of the Committee's objectives?

A: The proposed inclusion of the maturity factor deviates from the IRB framework, which assumes a 1-year capital horizon. For maturities exceeding one year, the MSFA would result in a capital charge across all tranches of a securitisation that will exceed the IRB charge for the underlying pool. As securitisation does not impact the total amount of risk that is associated with the pool, it would be appropriate for the maturity to be defined the same way as in the wholesale IRB framework.

Furthermore, the parameter 'tranche maturity' is generally accounted for in the methodologies applied by rating agencies. In order to avoid double counting, it should be left out of scope.

Question 17:

Is the proposed 20% risk-weight floor set at an appropriate level? Please provide justification and evidence, to the extent possible, for alternative levels for the risk weight floor.

A: At this point the floors are not the main concern. Quite frequently, the cap is below the floor. The floor as it is currently being proposed penalises senior and high quality tranches. The floor should be based on the associated credit risk of the asset type (CDOs of ABS, for example, have a significantly different track record than Dutch RMBS or corporate receivables). It would be more suitable to create a formula or a lookup table, making the floor more risk sensitive.

Question 18:

Should the risk-weight floor for short-term exposures be the same as for longterm exposures?

A: The answer to this question depends on the definition of maturity that will be used in the ultimate approach. If, for instance, the maturity for conduits would be set at one year, a lower floor would seem appropriate in such cases. Also, please see the answers to question 6 and 17.

Question 19:

Are the proposed caps and their interactions with the proposed floor risk weight appropriate?

A: The introduction of a risk weight cap for senior tranches (irrespective of whether it is rated or not) results in a bank not having to apply a higher risk weight to a senior tranche, than if it held the underlying assets directly. This appears logical and appropriate, given the credit enhancement that a senior tranche receives from subordinated tranches. As discussed earlier in the letter, it is important to facilitate banks investing in senior tranches to be able to apply the cap without disproportionate efforts. The best way to do this is by requiring issuers to disclose the weighted average risk weights of the underlying exposures as determined by the originating bank for its own regulatory capital requirements reporting. It should, however, be noted that a more fundamental review of the proposal is in our view preferable. The cap could serve as a fail safe, should the proposal not be fundamentally changed.

Question 20:

Are there other approaches that could provide a more risk-sensitive treatment while still being prudent and operationally straight-forward to implement?

A: Please see the proposal outlined in the first part of this letter and the answer to question 4.

Question 21:

Are the assumptions used in developing and calibrating the approaches discussed above appropriate in view of the Committee's stated objectives? Please provide empirical justification for alternative assumptions to those noted above.

A: We do not believe they are, especially for senior tranches of retail securitisations, as discussed earlier on page 2. Preliminary tests show that capital requirements for retail mortgages under SSFA can be lower than under the MSFA. For retail pools, the MSFA can produce higher capital requirements than the SSFA. This is the wrong incentive.

Question 22:

Is the proposed treatment of retail securitisations using the same approaches as for corporate securitisations appropriate? Would additional complexity (in the form of an additional formula to adjust the AVCs of retail underlying exposures) be justified to remove the double-counting effect of maturity effects?

A: The proposed treatment of retail securitisations does not appear to be appropriate. The current proposal would penalise real economy lending, as was discussed earlier. It is advisable to construct the approaches in such a way that would keep it as close to existing regulation for corporate and retail exposures as possible.

Question 23:

How could concerns that securitised retail exposures have high default risk or high correlation be managed? Please provide data supporting any modifications to the proposed approaches, particularly the MSFA and revised RBA, to account for differences in risk based on underlying exposure types.

A: As the proposed framework penalises high quality assets, such as retail loans (especially mortgages), an alternative approach for retail exposures would be very welcome. Only in jurisdictions where default risk and/or correlations are elevated, should these parameters be revised.

Question 24:

Is the relative calibration of the approaches appropriate? Please provide empirical data to support any conclusions.

A: Based on our analysis, we believe the RBA has been calibrated to match the MSFA. Therefore, the same issues apply to both approaches.

Other remarks:

On page 17, the Basel Committee mentions: *“(iii) Preferential credit conversion factor for eligible liquidity facilities under the SA Under the current SA securitisation framework, eligible liquidity facilities are subject to a 50% credit conversion factor. In an effort to further simplify the framework by reducing the number of exceptional approaches, the Committee proposes to eliminate the special treatment for eligible liquidity facilities as articulated in paragraphs 576 and 579 of the current Basel framework.”* Although we welcome efforts to simplify the framework, we do not feel changing the CCF is appropriate, when looking at the observed behaviour.