Brussels, 18 March 2013

EACB position paper on BCBS revision of securitization framework

Secretariat of the Basel Committee
on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland
baselcommittee@bis.org

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Consultative Document: *"Revisions to the Basel Securitisation Framework"*

Ladies, Gentlemen,

The European Association of Co-operative Banks (EACB) welcomes the opportunity to comment on the BCBS consultative document *"Revisions to the Basel Securitisation Framework"*.

Please find our general remarks and responses to selected questions in the following pages.

We will remain at your disposal,

Yours sincerely,

Hervé Guider
General Manager

A. GENERAL REMARKS

EACB appreciates the work of BCBS on the securitization framework and the opportunity to express its views on the resulting consultation paper and the proposed changes.

We would like to remind that co-operative banks' business model is not based on selling commoditised credits (OTD, "originate to distribute") but, with the aim of responding to the needs of their members/customers, it is based on a more traditional "intermediation role" along the OTH ("originate to hold") model. Nevertheless, on behalf of a few co-operative banks, EACB would like to put forward a some concerns relating the proposed methodology:

- The proposed risk weights for securitization positions are a multiple as compared to the case if the portfolio were held directly (risk weights in RRBA are excessively high, in particular for investment grade ratings). The proposed weighting does not seem to reflect the actual risk but imposes excessive capital charges for the securitisation positions.
- Cliff effects are not removed, especially for highly rated assets and especially in the case of alternative B.
- The credit enhancements do not seem to be taken into consideration.
- The assumption that securitization positions performed poorly does not hold for EU securitization market, which actually performed in line with expectations for most asset classes and geographic areas, even during the crisis.
- Some regulatory changes already address the shortcomings of securitization: risk retention rules, Basel III liquidity requirements, regulation aimed at improving the supervision, control and performance of rating agencies
- The alternative B does not seem to be completely specified and would impose significant problems. W favour alternative A.
- The IAA under alternative A should be strengthened by: bringing it at the same level as MSFA, extension of the scope of IAA (to apply to other securitization positions than ABCP), recalibration of risk weights in IAA to be more representative of the risk they refer to. We are also critical of the right of the jurisdiction to choose in level 2 of alternative A of the hierarchy. The institutions should rather choose depending on the available information between RRBA or SSFA.

  Thus, the hierarchy should rather be:

  1) appropriately calibrated MSFA or IAA (at institution's choice)
  2) appropriately calibrated SSFA or RRBA (at institution's choice)
  3) BCRA
  4) 1250%

- There should be a grandfathering provision for existing securitization positions – the new rules should only be applied for the new securitization positions going forward.

More details about our main concerns can be found in the responses to the specific questions.

B. ANSWERS TO SPECIFIC QUESTIONS

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?

Taking into consideration the general comments above, we favour alternative A. Alternative B introduces significant cliff effects, is too complex and does not seem to be appropriately calibrated. We also have significant concerns with regard to alternative A, generally related to the much too conservative resulting capital requirements that do not reflect the actual risk of the positions.

Moreover the requirement to calculate the capital requirements for every individual exposure in the pool on the basis of the IRBA, in order to use of the MSFA is excessive and will lead to either higher costs for customer or to avoiding the securitization altogether.

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?

We have serious concerns relating to level playing field and incentives for regulatory arbitrage in case the choice between the RRBA and SSFA is left at the discretion of national jurisdictions. The decision on which method to use should be left to the institutions.

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?

We do not favour the use of alternative B. However, in case it will be considered, we have some concerns relating to the methodology of ranking the quality of securitization positions. The use of external ratings in ranking the quality of the securitization positions should be possible, but not be restricted to this. In this respect it is useful to accept, as a first step, that, for example, a position in a senior investment grade tranche is classified as senior high quality. As a second step this can be tested by means of other criteria such as: the quality of the securitized assets, the track record of the originator and other criteria.

The Committee must take into consideration that allowing different methods of ranking the quality of a tranche does not serve the aim of creating a level playing field. There must be binding criteria that can be applied at national level, European and also for US banks. Also originators and sponsors should be responsible for communicating to investors if a senior tranche is high quality or not, based on uniform criteria.

The alternative B, as currently drafted might impact the stability of international financial system as originators, sponsors and various investors might have different opinions about the quality of a tranche based on different methods under alternative B.

It is also expected that alternative B will indeed lead to significant cliff effects when an exposure moves from senior high quality to non-senior high quality.

Question 4:
Are there alternative hierarchies or revisions to the two proposed (or a combination of both) that the Committee should consider?

With regard to alternative A, the Committee should place the IAA at the same level with the MSFA. This is reasonable, as the strict criteria for application of the IAA, the approval and continuous monitoring secure against a faulty application of the IAA.

Likewise, the IAA should be permitted for other securitization positions. This approach would satisfy the Committee's objective to reduce reliance on external rating, and these internal approaches would require specific and explicit approval from the local regulator after back-testing review.

Also as mentioned in our general comments the hierarchy should rather be:

1) appropriately calibrated MSFA or IAA (at institution's choice,)
2) appropriately calibrated SSFA or RRBA (at institution's choice)
3) BCRA
4) 1250%

In addition, see comment to Question 2 and general remarks for additional concerns relating to the proposed hierarchies.

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.

The use of two external ratings can indeed seem to reduce the model risk of rating agencies. However, the costs and benefits have to be carefully considered. Currently the regulation already requires banks to use the second best rating in case there are two available ratings

With regard to a mandatory use of two rating we remind that during the crisis all rating agencies have made adjustments to their assumptions. It is thus doubtful that this will avoid significant errors of various rating agencies in assessing the risks thus the benefits might be insignificant. Moreover, the strict obligation to use two ratings goes against the aim of the committee to reduce the overreliance on external ratings.

In addition, in the past there were cases when a rating agency has withdrawn its rating. This might lead to a situation where two ratings aren't available.

For the above mentioned reasons, we believe that a single rating should also be allowed in cases where two ratings are not available.

Question 6:
Is the RBA appropriately calibrated and formulated? Should other risk drivers be incorporated?

An empirical analysis on the default rates (default rates for S&P, impairment rates for Fitch and Moodys) of externally rated ABS-papers has showed that there are significant differences in the default rates of similarly rated asset depending on the asset class and region. This means for example, that the default rates of US AAA rated RMBS class can be a higher by a multiple than the AAA rated ABS class. This means that in the past the rating agencies did not appropriately distinguish between asset class and region.

This is problematic as assets under RRBA with similar ratings may not be traded uniformly depending on asset class and region. These two characteristics are essential risk drivers which need to be appropriately considered by the RRBA, as long as the external ratings do not reflect in a correct way the default rates.

Our understanding is that the Committee's proposed approach is calibrated based on corporate loan obligations. In light of the comments above a calibration based on one asset class/region might not be appropriate. The calibration should be done using multiple, better representative asset classes.

Moreover, we see no reasonable correspondence between the foreseen significant increase in the risk weights of the previously low weighted assets and the historic default rates. The risk weights are much higher than the risk they are trying to reflect, in particular for highly rated assets. The significant change in the treatment of external ratings could potentially harm the stability of the financial system. The introduction of the cap on risk weights offsets only to a small extent the negative effects of the new calibration. It is doubtful that it will lead to a reduction in the cliff effects that could justify the macro-economic costs.

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?

We do not believe such a provision is appropriate. In its proposals, the Basel Committee assumes that mixed pools are an exception. In practice, however, most pools tend to be mixed pools. Currently, a securitisation position may be recognised for securitisations under the IRBA approach if the majority of its securitised portfolio consists of IRBA positions. This approach should be kept as it will provides incentives for banks to use the more advanced and risk sensitive approach.

There are institutions where there is a IRBA rating system for a part of the portfolio and for the other part there is no IRBA system. The result would be that for a reference portfolio consisting of assets from both classes the MSFA is not applicable. However, in many institution it is not possible to develop an IRBA rating system for all asset classes in a reference portfolio, as the necessary data for development of such a system is not always available. For example, for an institution which has no mortgage loans for households, it is impossible to develop a IRBA rating system for private mortgage loans. This could result in the institution making no investments in such securitization for which it has not IRBA system.

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?

The MSFA is not appropriately calibrated as it leads sometimes to much higher requirements for a securitized position than it would lead if the underlying portfolio would be held directly. Especially for long maturities, the calibration seems excessively conservative

Moreover, since the cap and the floor are rather close, the proposed methodology is not risk sensitive. Relevant adjustments should be made.

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)?

The MSFA should be allowed both for banks making use of foundation and advanced IRB. These methods yield comparable results.

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?

It is unclear how the factor p is calibrated and what are the presumptions taken into consideration. A p equal to 1.5 seems rather excessive, being three times higher than the current p in use in the US.

Question 12:
Has the BCRA been appropriately calibrated and formulated?

The proposed BCRA does not recognize the effect of credit enhancement. This could create capital charges that are not in line with the economic risk. Even if the BCRA should exclusively serve as a fall-back solution, the calibration should still be economically appropriate.

Because of the stringent conditions of MSFA and the two ratings are required for the RRBA, BCRA could easily become the default application case for calculating capital charges applicable to securitisations.

Moreover, F depends on the seniority of the tranche which raises the major issue of the cliff effects.

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 F=2 for senior tranche (the BCRA RW of the senior would be equal to 2 times the RW of the pool) is too conservative as it violates the principle of the cap of the senior tranches.

Question 14:
How prevalent and material are securitisation exposures backed by mixed pools?

Mixed pools are common.

Question 15:
Is the proposed treatment for mixed pools appropriate, or should another approach be employed?

It is preferable, also taking into consideration the increased complexity, to use an alternative method to use IRB and MSFA on a pro-rata basis. (see argumentation in question 7)

Question 16:
Is the definition of maturity appropriate, in light of the Committee's objectives?

The tranche maturity is accounted for in most methodologies applied by the rating agencies. It should not be considered again in the framework of RRBA, in order to avoid double-counting.

According to the consultative document BCBS intends to require that "the contractual payments must be unconditional and must not be dependent on the actual performance of the securitised assets". However, contractual payments in a securitisation program inherently depend on the performance of the securitized assets. Thus the condition can hardly be met. Banks would generally be forced to focus on the longest, contractually permissible maturity. In general, this would result in an exaggeration of the actual term to maturity.

The maturity definition should recognize the specificities and economic realities of the different types of securitization.

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.

It is unclear how the proposed floor risk-weight is determined. Moreover, contrary to the previously applied approaches, it does not differ between the different methodologies. This could lead to a lack on incentives to develop internal, more risk sensitive models.

The floor is too high and could lead to many situations when it is.

Question 18:
Should the risk-weight floor for short-term exposures be the same as for long term exposures?

No, the risk-weight floor for short-term exposures should be lower than for long-term exposures.

Question 19:
Are the proposed caps and their interactions with the proposed floor risk weight appropriate?

We appreciate the rule that the risk weight of the cap should be used if the cap generates a lower risk weight than the floor. However, as already said (see question 17), the risk-weight floor of 20% is too high.

Question 20:
Are there other approaches that could provide a more risk-sensitive treatment while still being prudent and operationally straight-forward to implement?

In both proposed hierarchies the IAA is disadvantages as compared with the MSFA. We believe that the IAA should be placed at the same level with MSFA and the choice of the method should be left at the decision of the institution. Otherwise, if the decision is at the option of the regulator, this can lead to an uneven playing field.

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?

As also mentioned in the response to question no. 6, the calibration based on corporate securitization is not appropriate. A retail portfolio provides more diversification and a better distribution around the expected loss significant.

A more granular assessment of the different classes of securitized assets, also depending on regions should be preformed. The calibration or RRBA should not take into account the maturity effect in the first place, as it is already reflected in the rating.

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.

The retail securitisations of European market proved to be resilient during the crisis as opposed to the case. This might be the result of local origination practices and legislation. A future methodology should be consistent with the actual default rates observed in the different jurisdictions.

Question 24:
Is the relative calibration of the approaches appropriate? Please provide empirical data to support any conclusions.

The BCBS should launch a QIS to test the relative calibration of the individual approaches. On the basis of the assumptions of the consultation document we do not believe that resulting capital requirements for the securitization positions are aligned with their risk. The calibration appears to be rather the result of a stress scenario and disregards the actual risk and performance of the reference portfolios which could affect the securitization market and the stability of the financial markets.