

# Position Paper Erste Group Bank AG

## **Position on Consultation Paper of the Basel Committee on Banking Supervision on Revisions to the Basel Securitisation Framework**

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Vienna, March 15<sup>th</sup>, 2013

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Erste Group was founded in 1819 as the first Austrian savings bank ("Erste oesterreichische Spar-Casse"). In 1997, Erste Group went public with a strategy to expand its retail business into Central and Eastern Europe. Erste Group's customer base has grown through numerous acquisitions and organic growth from 600,000 to 16.6 million, of which 15.5 million clients live in the fastest growing economies of the European Union. These countries benefit from the stable EU regulatory framework. Having always focussed on retail and SME business, today Erste Group is one of the largest financial services providers in Central and Eastern Europe in terms of clients and total assets.

Please note that Erste Group does not want its comments to be published or disclosed.

Erste Group welcomes the opportunity to provide comments on the proposals put forward in the Consultation Paper.

### **General remarks**

In our view, the underlying assumptions of the consultation paper are not representative for the entire market as it does not differentiate among the different asset classes. A lot of arguments and comments outlined in the paper relate to corporate securitisation and specific problem areas, but are not directly applicable to the prime sectors. We are of the opinion that there is a strong need to develop a far more differentiated approach on securitisation.

The revised set of approaches aims to reduce reliance on external ratings, reduce cliff effects, bring the current SA and IRB approach closer together and increase prudence and risk sensitivity. Under both proposed alternatives the result is a rise of the capital requirements for most securitisation tranches as all ABS asset classes irrespective of their historic performance and their primary purpose (arbitrage vs. funding) are treated the same.

### **Structural elements in new approaches**

The Backstop Concentration Ratio Approach (BCRA) takes no subordination (hard credit enhancement) for senior classes into account, i.e. the risk weight for a senior class will be equal to the risk weight of the underlying assets. On the other hand the negative feature of leverage of non-senior tranches is included. Furthermore, no benefit is given to excess spread (soft credit enhancement), triggers, waterfall sequence or liquidity facilities.

The R-RBA includes the tranche thickness. Moody's rating corresponds to the expected loss of a tranche which considers already the tranche thickness. S&P and Fitch base their ratings on default probabilities. Currently no adjustment is made in the revisions between different rating agency approaches.

Furthermore, rating agencies do already account for longer maturities in their ratings. Longer legal maturities result in higher loss rates and thus higher required credit enhancement in their models. Under the R-RBA there is in addition to the thickness (see Q5 + 6) also a maturity factor included which would lead to kind of double counting.

Moreover, we are of the opinion that the blame on the credit rating agencies' methodologies for downgrades within certain asset classes is an oversimplification, as it does not take into account the severe economic circumstances experienced in peripheral Europe and the US especially. Contradictorily, in some approaches set out in the paper, it is still relied on credit ratings to a rather great extent.

In our view a concept of counterparty risk is missing. Counterparty risk has been a prime driver of many downgrades; however, the capital requirement is wholly based on the performance of the underlying portfolio.

### **Comparison to other asset classes**

Regulators seem to find external structured credit ratings and bank internal models for this asset class less reliable than corporate or covered bond ratings. As a result risk weights were more conservatively stressed to diminish the model risk.

According to the new R-RBA approach an AAA rating for a 5 year securitisation needs the same risk weight as an A-rated corporate bond. In comparison to covered bonds the rating difference is even more extreme: Under the Standard approach a B-rated covered bond requires the same risk weight as a 5 year AAA rated senior ABS tranche.

Securitisation would be one of the few asset classes for which a time horizon above one year is used under the new MSFA and R-RBA approaches.

Risk Weight floor of 20% versus other similar asset classes such as covered bonds which can have risk weights below 20%.

### **Regulatory level playing field**

We think that the motivation for revising the securitization framework should be a creation of a level playing field for the assumptions a credit institution can make. As for the performance and cliff effects of all securitisations at the moment various different degrees of accuracy and capital adequacy for the same product can be considered by various institutions.

Under both hierarchies A and B, national discretion is proposed (please refer to our answer to Q2) which should be avoided in order to reach a level playing field.

### **Effects to structured finance market and economy**

The merits of securitisation as crisis mitigation function and in financing the real economy are not appropriately represented in the paper.

According to Barclays research 60-70% of all newly issued European ABS were bought by banks in 2012. Given the higher capital requirements, investments in ABS will result in far lower return on capital (R-RBA 42% for senior UK RMBS tranche, 7% for AA tranche vs. current IRB 166% senior and 125% for A tranche). Due to the reduced attractiveness, banks could – if at all – focus on senior tranches only which will make the issuance of new transactions more difficult and unattractive for originators from a RWA relief perspective. This could cause unintended negative effects to the European real economy and the housing market.

Certain sub sectors (US HEL, Alt-A, Re-securitisation) loss rates and rating migration were used by the regulators to apply disproportionate risk weight levels for the overall market ignoring the strong performance of sectors serving the real economy as important long-term financing instruments. Moreover, the sub sectors used as basis for the risk weight recalibration have been virtually non-existent since the start of the crisis whereas the sectors contributing to the lending in the economy such as high quality RMBS and

Consumer ABS that have started to recover from their post-crisis issuance lows will get heavily penalised and hinder economic activity.

The regime as outlined in the paper will ban securitisation as a whole and could promote a shift of regulated banking activity into the unregulated shadow-banking field.

### **Specific remarks**

***Q2: 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 doubt that. Under alternative A, if a bank could not use the MSFA for a given securitisation exposure, it would then use either the revised RBA or the Simplified Supervisory Formula Approach (SSFA). The decision to apply either the revised RBA or the SSFA would be made by the local jurisdiction.

However, the Revised RBA in alternative hierarchy B raises concerns about a level playing field, too. The Committee is proposing to include a provision within the Pillar 1 securitisation framework that would give explicit discretion for national supervisors to adjust upwards capital requirements for securitisation exposures backed by high-risk pools.

***Q3: 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 understand the rationale to push all non-senior tranches into the concentration based approach. Leaving the distinction between high-quality and other tranches up to, amongst other things, (the bank's own assessment of credit risk) the banks would again lead to differing risk weights for the same asset for different holders. Therefore, the concern regarding cliff effects from approach changes is very valid.

***Q5: The Committee recognizes 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' modeling risk with the costs of using two ratings and/or whether exceptions to this treatment should be permitted.***

***Q6: Is the RBA appropriately calibrated and formulated? Should other risk drivers be incorporated?***

To require a minimum of two ratings per transaction would leave a number of transactions being excluded from the RBA approach. Even today where most transactions are rated by at least two agencies a number of deals only carry two ratings for the senior tranche, with mezzanine tranches holding just one rating.

Two ratings generally reduce the dependency on one particular rating agency and also reduce rating arbitrage but they also introduce rating volatility and corresponding RWA swings. Grandfathering of legacy transactions would mitigate this somewhat.

To differentiate between senior and non-senior tranches under the RRBA approach is very plausible but the proposed differentiation seems too drastic – especially in absolute risk-weight percentage points. The tranche thickness is an important default and loss driver and hence is also reflected in rating agency ratings (whether explicitly as in case of Moody's expected loss approach or implicitly as in the case of S&P, Fitch and DBRS under their probability of default approach). A special scale for different tranche thicknesses is therefore mostly complicating regulatory capital reporting. At least the technical note to be released should give more insight regarding the data used for these calculations.

In its intention to reduce cliff effects in the RBA approach the committee generated the following additional discrepancies within the R-RBA RW calculation:

Risk weights for the best performing, AAA rated, senior, seasoned European ABS (UK, Dutch prime RMBS, Auto ABS) would increase disproportionately although they have shown strong historic performance throughout the 2007/08 crisis, the ongoing Eurozone crisis and the current difficult economic environment. These sub-sectors would be more penalised (8-12 times higher capital charges) than downgraded peripheral Portuguese or Irish RMBS (5-8 times increase).

In addition to the general rise of senior class capital requirements, most mezzanine tranches have a thickness below 10% or up to 25% at issuance. For these classes all risk weights increase considerably across the rating spectrum. Instead of the intended reduction of cliff effects for these tranches the risk weight curve is shifted north (higher risk weights for AAA to A rated classes) and starts to steepen earlier from A (220% for 1 year thin bond) to BB (1181%) compared to the current ratings based approach.

***Q10: 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?***

There is a significant difference in the SSFA Basel – US calibration parameter: Basel  $p=1.5$ , whereas under US rules  $p=0.5$  is applied which would increase the capital requirement for European banks compared to US banks holding the same ABS tranche.

In addition to that, under the US no maturity factor is included in any approach.

Hence, the Committee should aim at a regulatory level playing field.

***Q16: Is the definition of maturity appropriate, in light of the Committee's objectives?***

The definition as proposed in the paper will result in the fact that virtually all tranches under either hierarchy will be treated as having a maturity of 5 years since repayments will always depend on either a call or re- (and pre-) payments of the underlying portfolios. Legal final maturities for many deal types and especially for retail securitisations such as RMBS are usually 30 years out.

***Q19: Are the proposed caps and their interactions with the proposed floor risk weight appropriate?***

Comment relating to the interaction between floors and caps: On the basis of the explanations in the paper, for example a high quality senior RMBS note could theoretically have a calculated capital weight of zero. We ask the Committee to provide a worked example of the quality/credit enhancement required to pierce the 20% floor.

Comment on Early amortisation provision revisions (page 33): In the case of revolving credit exposure transactions such as RMBS master trusts for example, there is risk transfer from originators/sponsors to investors. The sponsor should not have to treat the full portfolio of securitised assets as on balance sheet. The sponsor's exposure to the credit risk of the master trust is clearly capped at the seller share. We ask the Committee to clarify why this needs to be changed.

***Q22: 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?***

***Q23: How could concerns that securitized 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 Committee states that there is double-counting in case of maturity effects. The extremely low default evidence in particular in European prime securitisations gives cause for the concern that the revision would overstate credit risks whereas in fact the realised securitisation defaults and losses have in most cases (e.g. Prime RMBS) been far less than in non-securitised portfolios. This needs to be adjusted.

We feel that guidance is essentially needed regarding timeliness for updating assumptions if performance of a portfolio worsens or improves. The lack of policy in this regard could lead to further inconsistency and market distortion; a bank that attributes a lower capital weighting to a bond than its competitors will have a distinct advantage.

According to this paper cliff effects are deemed necessary to be reduced (page 1, para 2), however, these proposals create a cliff of their own – across the board increase in RWs. It even is admitted on page 36 para 1 that the proposal will result in a significant increase in risk weights.

As the performance of a transaction worsens, its rating deteriorates and its RW increases. Furthermore, if it deteriorates to a large extent, it will require full capital weighting or else a combination of an impairment and a very high capital weighting on the remainder. This is already extremely penal. The proposals effectively pre-empt future downgrades based on historic poor performance of certain sectors of the market.



Yet the RAs have already addressed certain of the methodology mistakes and the hurdles to a high rating are now set higher than ever. The impact of these proposals, if enacted, would reduce the attractiveness of securitised products to investors and thereby close off securitisation as a funding tool to everybody including the vast majority of issuers who have used it prudently and successfully to date. Holders of existing securitised issues will need to assign significantly higher levels of capital to their current portfolio. The likely impact of this combination would be a further restriction of the availability of credit to borrowers.

***Q24: Is the relative calibration of the approaches appropriate? Please provide empirical data to support any conclusions.***

#### **Calibration of the approaches – CLOs as basis**

The MSFA and the R-RBA have been calibrated by applying loans performance (from CLOs) with a 4.73% PD and 60% LGD. Thus, corporate performance was used also for the well-performing European retail ABS sub sector such as RMBS and Auto ABS.

Rating migration from CLOs has been particularly negatively affected by rating methodology changes since the start of the credit crisis. According to Fitch CLO AAA classes migrated to AA until mid-2011 whereas UK prime RMBS AAAs migrated during that time to between AAA and AA+ and European consumer ABS such as Auto ABS to AAA/AA+ from 2007 to 2011.

Another Fitch study shows that 73% of already experienced and expected losses for the total ABS universe of the 2000-2011 issuance are from US subprime, US SF CDOs and US Alt-A. 3 now defunct sectors contributed to almost 75% of the 4.9% average loss of (realised 1.9% and further expected losses 3.0%) the whole structured finance universe. The proposed new R-RBA would require a bank to hold 4.64% capital (or a risk weight of 58%) for a AAA, 5-year senior ABS bond similar to the average loss rate without taking the performance differences into account. For European ABS and European RMBS the loss rate is 0.22% and 0.25% respectively. As these losses also include non-senior tranches the loss for senior tranches is almost zero. But even with ignoring that fact the capital charge is still around 2000% the total loss rate.

Based on these figures we strongly propose adjustments for retail exposures given their historic performance, their economic benefit and essential funding role.