Response to BCBS's Securitisation Framework

Gordian Knot

8th April 2014

This memo is submitted in response to the Basel Committee on Banking Supervision's (BCBS) consultative document "Revisions to the Securitisation Framework", published 19th December 2013.

Contents

Executive summary

The revised BCBS proposals are a step in the right direction but continue to show a strong bias against securitisation versus other types of bank assets, such as loans and covered bonds. In this response, we draw attention to how high securitisation risk weights are when compared to those assigned to other asset classes and to central bank haircuts for repo financing.

We consider that both of these inconsistencies require the BCBS to go back to the G20 for further guidance as it is clear that the objectives set out by the G20 in 2010 (which then regarded securitisation as part of the problem) have changed. Senior policy makers now regard securitisation as an important financing technique for the real economy and are keen to resuscitate the securitisation market. This is evidenced by recent speeches by policy makers, the inclusion of senior tranches of securitisations in the Committee's own HQLA definitions for the Liquidity Coverage Ratio and recently reduced haircuts applied by the ECB to securitisation collateral.

The proposals have a continued reliance on mathematical models, with arbitrary inputs intended to obtain a predetermined output. We propose a much simpler alternative approach, which is an enhancement to the Return-Allocated Capital-Equivalent (RACE) Approach[1] and is consistent with established regulatory processes, and which adds in capital for risks other than credit risk.

Background

Gordian previously submitted a memo to the Committee with comments on the 2012 proposals and with the outline of an alternative, the RACE Approach, which proposed an alternative method for calculating securitisation capital requirements based on two principles:

1. **Capital Equivalence[2]**: that the capital required to support a securitisation in total should be the same as the capital required to support the underlying assets.
2. **Price Function Allocation**: relative tranche pricing can be used to identify the riskiness of each tranche of a securitisation, and can be used to allocate risk weights to each tranche in a capital equivalent manner.

We appreciated having the opportunity to present the RACE Approach at the Committee's April 2013 meeting in London, and are pleased to see that some of our proposals were recognised in the Committee's revised framework. Specifically, the new framework is significantly simpler, with fewer arbitrary inputs and less advanced mathematical models and, in general, is more reasonable in its treatment of securitisation risk weights. Further, the Committee recognises the importance of ensuring consistency with the underlying framework, particularly for senior tranches in Principle 3. Finally, in the 'Maximum capital requirement' section (p.18), there is a proposal for banks holding a vertical slice of a securitisation to hold a pro-rata amount of the capital charge for the underlying pool for its securitised holdings. This is an important step towards recognising the importance of capital neutrality.

We applaud the BCBS for continuing to engage the industry in a second round of comments on this important issue. Senior policy makers, politicians and regulators have repeatedly stated the case for

[1] http://www.bis.org/publ/bcbs236/gordian.pdf
[2] The Committee refers to this concept as "capital neutrality"

resuscitating securitisation as a powerful technique for financing the real economy through the banks. Pooling, tranching and selling of loan portfolios provides banks with an effective and lower cost alternative to raising both new capital and long term funding. Securitisation also allows banks to increase the liquidity of assets on their balance sheet by creating securities that are easily traded and repo'd. Furthermore, private market securitisation can create an exit route for very large central bank balance sheets, which are currently repo funding very significant securitisation positions for banks. Banks are central participants in this market; as originators and servicers of loans, structurers, traders and investors in securitisations, providers of derivatives and operational services for securitisations and as funders of securitisations for third party investors. The most senior tranches of securitisations, which typically represent a significant majority of the underlying loan pool, offer the lowest return and so are mostly held by funded investors, including banks. The Insurance regulation (Solvency II) typically follows what the banks are required to do. So capital risk weightings of securitisation tranches held by banks really does matter for the provision of credit in the real economy.

Securitisation risk weight objectives set by G20

We understand that much of the Committee's work has been guided by past G20 communiqués, and that the changes to the securitisation framework were seeded prior to 2010. Given that attitudes towards securitisation amongst senior policy makers have changed significantly over recent years, from one of seeing securitisation as a cause of the crisis to it being one of the tools for economic growth and re-emergence from crisis, we encourage the Committee to seek new guidance from the G20 about its ambitions for securitisation framework reforms. This would ensure that there is no dislocation in agenda, and that policy goals are better aligned with regulatory reform efforts.

Securitisation risk weights

The high risk weights assigned to securitisations under the revised BCBS framework continue to demonstrate a pervasive bias against securitisations that does not reconcile to their credit performance or with the current direction of policy making in central banks and supra-national bodies or with the haircuts required by central bank repo facilities. Punitive risk weights, under this framework for banks and Solvency II for insurers, will increase the barriers to the restarting of the securitisation market, as expounded by Messrs Draghi, Carney et al. As they have recognised, securitisation done properly can help banks rebuild their balance sheets and improve the flow of credit to the real economy.

The revised framework presented by the Committee continues to propose risk weights for securitisations that, while lower than originally proposed, are still higher than for other asset classes. We do not believe that this onerous treatment is warranted. Securitisation as a tool demonstrated that, when used simply and free of poorly underwritten credit, it functioned well during the crisis from a loss perspective[3], and that the legal structures provided investors with greater certainty of outcome than was the case for many financial borrowers. Yves Mersch, Executive Board member of the ECB, explained, the current framework is heavily steeped in the experience of US Subprime,

[3] See Fitch study "Global Structured Finance Losses", 02-Oct-13

which is akin to “calibrating the price of flood insurance on the experience of New Orleans for a city like Madrid”[4] when trying to apply this to the asset class as a whole.

The BCBS’s maturity definition, itself taken from earlier BIS work, will lead to virtually all securitisations being classed as having a 5 year or more maturity. This is because it is calculated based on contractual cash flows only, whereas securitisations are typically structured based on expected cash flows. Since most securitisations will be given a 5 year maturity classification, the following table illustrates the punitive capital treatment versus other asset classes (when using a ratings based approach):

Ratings Based Risk Weights	AAA	AA	A	BBB
Covered bond	10%	10%	20%	20%
Bank debt	20%	20%	50%	50%
Corporate bond	20%	20%	50%	100%
Securitisation[5]	25%	130%	190%	320%

Securitisation is a tool that creates a bankruptcy remote and transparent investment (typically with loan level data and monthly reporting schedules), with overcollateralization or credit enhancement for the more senior tranches and structural features designed to preserve cash flows for the benefit of note holders. By comparison, investments in corporate and financial entities are secured by cash flows from businesses that have a much wider range of credit risks: management teams that can vary credit metrics and capital structures, operations in many jurisdictions, less frequent and less transparent reporting, etc. Covered bonds do provide additional security compared to pure bank debt, in the form of collateral, but this security may not be a direct claim and the underlying credit positions can revolve in a less transparent manner than within a securitisation, where reporting is held to a higher standard. So it is clear that the proposed capital treatment is harsh and unjustified when compared to more opaque and complex investments, such as covered bonds or bank debt.

The world’s principal central banks, the Federal Reserve and ECB, have transacted a significant volume of repo funding of securitisation collateral since the start of the financial crisis. These institutions have established repo haircuts that are considerably lower than the BCBS’s capital requirement floor of 20% (for 5 year maturities). The table below shows the haircuts currently in place for 5 year securitisations:

Repo Haircuts		AAA	AA	A	BBB
Fed	Agency RMBS	4%			
	ABS	5%	14%		
	CDO	9%	N/A		
	CMBS	7%	N/A		
	Private RMBS	16%	N/A		
ECB		10%			22%

Source: Federal Reserve, ECB

[4] “SMEs, Banking Union, and securitisation - exploring the nexus”, Yves Mensch, 13-Nov-13

[5] We have assumed that AAA securitisations are senior tranches, and below-AAA are non-senior thin tranches without any thickness adjustment

When compared to the 20% capital requirement floor, these haircuts further illustrate the misalignment of the BCBS's proposed capital requirements for securitisations with those used by the major central banks. Since the central banks are only taking credit risk in executing these transactions this indicates that the BCBS's capital risk weightings are significantly overstated. We suggest that the BCBS may want to investigate the calibration of the Fed and ECB repo haircut framework, to better align their capital requirements.

Enhancement to the RACE Approach

The original RACE Approach proposal considered only the capital charge allocated to the underlying credit risk. The Principle 2 "Prudence" section of Objectives and Principles of the current BCBS proposals, suggests that there are additional structural features inherent in securitisation that would not be captured by our original approach.

In response, we broaden the concept of capital equivalence, to consider these structural features as constituent parts of the securitisation. Rather than using a complex model to capture these, we propose using existing bank capital requirement standards to allocate each constituent part of a securitisation a portion of capital. The sum of capital assigned to each of these additional risks, plus the capital assigned to the credit risk of the pool will form the total capital required for the securitisation (TSC – Total Securitisation Capital). The TSC can then be allocated across the tranches using the price function under the RACE Approach.

This enhancement maintains the core principles of the RACE Approach; capital equivalence and allocating capital using the price function, whilst addressing the Committee's concerns about un-captured risks. It is also entirely consistent with existing bank regulation, using established methodology to capture additional risk and avoids the creation of complex models that are not consistent with existing regulation.

In addition to the underlying credit risk, additional risks may be introduced into a securitisation in the following forms:

- Conflicts risk
- Operational risk
- Structural complexity
- Legal risk
- Swap counterparty risk
- Information asymmetry
- Model risk

Conflicts risk and information asymmetry are best addressed through established rules governing risk retention. As proposed in the RACE Approach memo, we believe that vertical retention by the originator, with the quantum of retention negotiated by investors during syndication, is the most appropriate way to ensure interests are aligned between issuers and investors.

We propose that the remaining risks can be adequately covered by using existing and established bank capital requirements standards pertaining to operational risk and counterparty credit risks. For each constituent item, the issuing bank will be able to calculate a capital charge, such that all additional risks are captured.

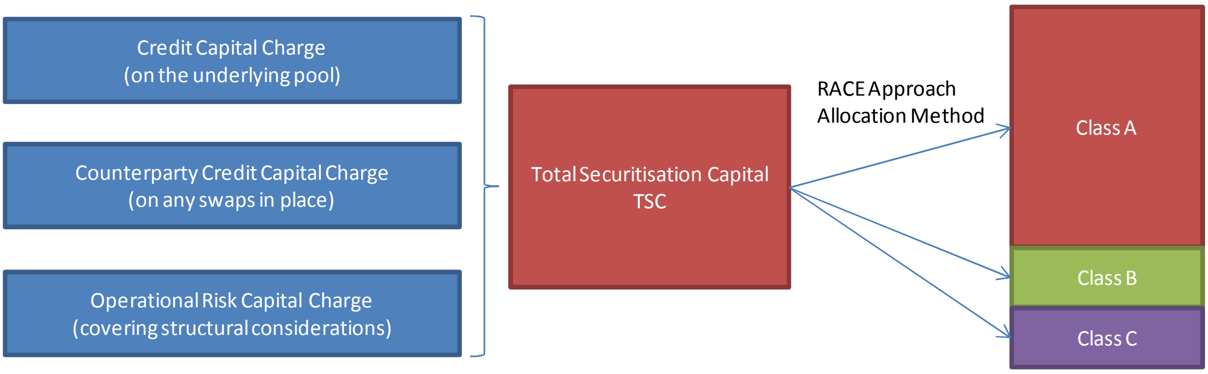
For example:

As originally proposed, the bank will first calculate the capital charge it would apply on the underlying loans, as if they were held un-securitised on its balance sheet. This amount will form the Credit Capital Charge, the foundation of the TSC.

If the securitisation requires swaps in place to exchange certain portions of the deal's cash flows, it must consider what capital charge these swaps would have required had they been executed on the bank's own balance sheet. This amount will form the Counterparty Credit Capital Charge, and will be added to the TSC.

In addition, the bank should be able to conduct an operational risk assessment that encompasses the other operational and legal risks that are introduced through the securitisation process. If the deal is complex and involves many jurisdictions and participants, this will be higher than if it is a simple structure. This has the added benefit of creating an incentive for the originator to structure simpler securitisations. The operational risk assessment will allow the bank to compute an Operational Risk Capital Charge that will be added to the TSC.

Once the TSC has been calculated, it will be assigned using the price function to all of the tranches issued out of the securitisation structure:



The operational risk assessment process may need to be adapted for such a purpose. It could be qualitative, in a rigid auditable manner, or more quantitative – considering the number of tranches, jurisdictions, deal participants, etc. It is important that such a process is risk sensitive to the structural complexities in a deal and accurately captures any risks introduced through the securitisation approach. This would allow for a capital framework that was still founded in the capital allocation to the underlying credit pool, as set out in the BCBS's Principle 3, but had an adaptable scalar that recognises the additional risks the BCBS alludes to in the proposed framework (Principle 2).

Summary

We appreciate the BCBS's continued engagement with the industry and request for feedback on the proposed new capital risk weights for securitisations.

We suggest that the BCBS continue to reflect on the impact the regulatory response will have on the future of the securitisation market (especially given that Solvency II is likely to follow the bank capital treatment).

We ask that the BCBS seek an updated mandate from the G20 to ensure that the aims and objectives of its framework are in line with those of senior policy makers as their rhetoric has changed significantly over the past 4 years.

We recommend that the BCBS should consult with the Fed and ECB whose market based repo haircuts indicate much lower risk weightings than proposed by the BCBS.

We believe that any new framework for securitisation risk weights should:

- Be simple; capable of being applied consistently by all banks and understood by all investors
- Not introduce disincentives or barriers to securitising assets on bank balance sheets
- Not discriminate against securitisation as an asset class when compared to others such as covered bonds, whole loans sales or bank debt
- Have a strong and transparent link between the capital required on the underlying credit pool and the capital required on the securitised tranches
- Be suitably risk sensitive with regard to any additional risks introduced through the securitisation process
- Reduce reliance on ratings as a regulatory input; leaving them as an expert opinion for investors only

We request that the Committee re-visit Principle 3, which states that although "capital neutrality is not desirable, capital charges should be broadly consistent with the capital charges for the underlying pool" as the current proposals would still lead to capital requirements for securitisations that are many multiples of the charges on the underlying loan pool.

If additional capital charges for counterparty exposures and operational risks are layered on to the underlying credit risk charge, then there should be no need to add further arbitrary charges on to the securitisation. On this basis we consider that the refinements to the RACE approach, presented here, creates a simple, transparent, non-discriminatory alternative that is entirely consistent with the goals of policy makers.