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By email: baselcommittee@bis.org

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Sirs

Consultation on Revisions to the Basel Securitisation Framework

We refer to the consultative document on the “Revisions to the Basel Securitisation Framework” published by the Basel Committee on Banking Supervision (BCBS) in December 2012. On behalf of our members, we write to provide our views on the proposals in the consultative document.

We are generally supportive of the BCBS’s stated objectives to make the Basel capital framework’s treatment of securitisation exposures more prudent and risk sensitive, mitigate mechanistic reliance on external credit ratings and reduce cliff effects. However, we are of the view that the proposed revised framework may not be appropriately calibrated and we have concerns about the impact of the revised calibration and the potential unintended consequences on the financial market and the global economy as a whole.

Firstly, the incorporation of maturity factor (M) may cause a material distortion in capital requirements for securitisation vis-à-vis the IRB framework for underlying assets. This distortion is particularly pronounced for securitisation of short-dated assets such as working capital loans and trade financing. We believe banks will find it economically prohibitive to securitise these assets for risk mitigation or capital relief purposes. This will likely reduce available credit capacity, particularly for small and medium-sized businesses that tend to depend on such working capital and trade financing loans. This may have repercussions on global trade and economic growth.

Secondly, the proposed revisions are calibrated based on a limited set of empirical data which may not reflect the performance of bank balance sheet securitisation transactions. We therefore are concerned that bank balance sheet securitisations will be unfairly penalized with higher risk weights that are calibrated with other

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types or classes of securitisation transactions in mind. In particular, we believe that the 20% floor is set too high and may potentially make bank investors uncompetitive compared with the lesser-regulated "shadow banking system".

In fact, we are of the view that proposed revisions will add further complexity to the securitisation framework and this may create opportunities for arbitrage, lack of transparency and comparability across deals and difficulties in administering the framework.

We are also mindful that various recent regulatory changes have already been put in place to strengthen the capital and liquidity positions of banks. The combination of these changes in conjunction with the proposed revisions to the securitisation framework may potentially result in over-estimation of capital requirements on an aggregate basis.

Furthermore, it will be appreciated if the framework can also address the arrangement of 'grandfathering' of transactions executed prior to the publication and implementation of final rules in order to accommodate a managed implementation and an orderly adjustment of capital requirement.

Finally, please find attached in the Appendix our response to the list of questions raised by BCBS.

We hope you would find our comments useful. Should you have any questions, please do not hesitate to contact our Senior Business Manager, Ms Caris Wan at (852) 2521 1855.

Yours sincerely

A handwritten signature in black ink, appearing to be "Boey Wong", written over a horizontal line.

Boey Wong
Secretary

Enc.

cc. Ms. Karen Kemp, Executive Director (Banking Policy), Hong Kong Monetary Authority

HKAB's Comments on BCBS consultative document on the Revisions to the Basel Securitisation Framework

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?

Under Hierarchy B, a senior high quality tranche (SHQ) and a non-SHQ would result in a different application of capital treatments (RRBA / MSFA vs CR_{KIRB}), a deterioration from SHQ to non-SHQ may be more prone to a material cliff effect (refer to Question 3 for more discussion). Since the SHQ criteria have not been clearly defined, subjective interpretations among banks and jurisdictions may lead to different applications and thus regulatory arbitrage opportunities. Although the Proposal also stated that "high quality would correspond to a long-term credit rating of "AAA" to "AA-," or short-term credit rating of at least "A-1/P-1/F-1." The points of reference used to determine "high-quality" are based on standards established by external credit ratings and therefore, do not effectively support the Committee's objectives of reduced reliance on external credit ratings.

Hierarchy A seems relatively better in addressing the Committee's objectives as it introduces more flexible alternatives before the application of overly conservative Backstop Concentration Ratio Approach (BCRA).

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?

The revised RBA calculation is based on external credit ratings, while the SSFA model is driven by the underlying exposures' weighted average capital requirement. The latter requires details of underlying data for securitised assets which may not be at all times available to investors. The revised RBA method seems more practical to Asian users from a disclosures perspective despite there may be varied responses as driven by Dodd Frank requirements yet to be fully seen.

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?

Alternative B is likely to produce material cliff effects as exposures deteriorate from SHQ to Non-SHQ. Given that CR_{KIRB} is not permitted for non-IRB banks and banks that cannot

estimate IRB parameters for all of its underlying exposures in a given transaction, the conservative BCRA would be the defaulted approach. For high quality mezzanine tranches with credit enhancements, the cliff effect could also be material, given CR_{KIRB} and BCRA would not consider the credit enhancement attached.

As mentioned in the answer to Question 1 above, the proposed method (based on external credit ratings) to determine if a securitisation exposure is of high-quality seems to contradict the Proposal's objectives to reduce reliance on external credit ratings.

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

The Committee should note that the U.S. proposal would risk-weight resecuritisation in the same approaches (i.e. the SFA or SSFA) as other securitisation exposures whereas the suggested BCRA approach would not even take into account credit enhancements or seniority into the resecuritisation calculation. Such treatment could be overly conservative and hence a concern on level playing field.

Question 5: 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.

Recent history has demonstrated that multiple public ratings do not necessarily translate into reduce modelling risk in rating agencies' models. In fact, mandating a minimum number of public ratings might lull some investors into a false sense of security. The primary drivers for having multiple public ratings should be due diligence consideration and preference of investors.

In some Asian jurisdictions (e.g. China, Malaysia, Thailand), international rating agencies are actually not deployable in part for reasons of local license for domestic rating purposes. Yet on the other hand, domestic rating agencies that are recognised in these local markets may not have attained the same degree of international recognition.

These situations should be considered to permit an exemption from requiring two external ratings of internationally recognised agencies. Especially if Hong Kong Monetary Authority regulated banks are to explore specific markets of large growth potential (such as the onshore RMB market in Mainland China), the punitive risk weighting treatment for "unrated" securitisation will not be helpful especially in cases where certain home regulators allow their domestic banks to risk-weight on a more lenient basis.

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

No. The maturity calibration in revised RBA may have to some extent double counted the impact of maturity which should already have been accounted for by credit ratings. It is also unclear why the maturity factor alone should increase the risk-weight to such large extent, particularly on the higher rated tranches. For instance, an AAA-rated tranche may have a risk-weight increase from 2.9 times to 8.75 times, should the tenor be increased from 1 year to 5 years.

In fact, the calibration of revised RBA which incorporates tranche maturity (M) significantly increases misalignment in the revised RW for securitisation positions vis-à-vis RW of the underlying assets. This can be shown by comparing (X) the aggregate RWA of the full capital structure (consisting of sold and retained tranches) using proposed revised RBA with (Y) the aggregate RWA of the pool of securitised assets under IRB. The main reason is the introduction of maturity factor (M) which causes (X) to unhinge from (Y).

It is also noted that the cliff effect from negative rating migration is in fact wider with starting point from 20% for the better rated tranches. This may inappropriately penalise banks from holding better quality assets.

Furthermore, the 20% floor should be removed, as it does not seem to reflect the actual loss expectation. Please refer to Question 17 for more discussion.

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?

Commingling of a small proportion of assets under Standardised Approach (STD) into a pool of predominantly IRB assets should be allowed. Most IRB banks have small or niche STD books that are not sufficiently diversified to support structured credit hedging underpinned by 100% STD assets. The 'dominance test' currently proposed under CRD IV Article 104 should be allowed in order to provide banks with an avenue to hedge these STD exposures.

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 requirement to estimate IRB capital requirements for all underlying assets is difficult for investors in practice unless they are also originators of the securitised transaction.

Industry generally believes that as maturity is already an input in the K_{IRB} calculation, the maturity calibration in MSFA formula may to some extent have double counted the same maturity impact.

In fact, the calibration of MSFA which incorporates tranche maturity (M) significantly increases misalignment in the revised RW for securitisation positions vis-à-vis RW of the underlying assets. This can be shown by comparing (X) the aggregate RWA of the full capital structure (consisting of sold and retained tranches) using proposed MSFA with (Y) the aggregate RWA of the pool of securitised assets under IRB. The main reason is the introduction of maturity factor (M) which causes (X) to unhinge from (Y).

We acknowledge that the calibration of tau and omega is not unreasonable.

20% floor should also be removed. Please refer to Question 17 for more discussion.

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)?

Yes. It is not unreasonable to allow banks on Foundation IRB (FIRB) to apply MSFA on their balance sheet securitisation. This is because the prescribed LGD in FIRB tends to be higher than modeled LGD in AIRB. For two identical pools of securitised loans, this translates to higher K_{IRB} % under FIRB than under AIRB, which means a bank under FIRB would have to distribute higher up the capital structure than a bank under AIRB. Hence, it can be argue that there is no added incentive for FIRB bank to apply the MSFA.

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?

The industry believes that add-on p factor of 1.5 in the proposed SSFA formula is significantly higher than that of 0.5 used in the U.S. proposed SSFA. This creates a concern on level playing field.

20% floor should be removed. Please refer to Question 17 for more discussion.

Question 11: Is the SSFA properly formulated or should other risk drivers, such as maturity, be incorporated?

The SSFA uses a single formula to determine the risk weightings of all tranches, including high-quality senior tranches, mezzanine tranches and first-loss positions. High-quality senior tranches with credit enhancement could be heavier risk-weighted than simply holding the underlying assets directly. More careful distinction should be made to accommodate different compositions of credit risk structure. On the other hand, the U.S. SSFA proposal has no explicit maturity input which is considered to have complicated the formula.

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

The formulation and calibration of BCRA is far too conservative as clearly demonstrated by the example in Figure 1 (page 28) of the Consultative Document where the ~\$35 aggregate capital charge of all tranches (in the capital structure) is 3.5X the \$10 aggregate capital charge of the pool of underlying loans. The resultant difference in their risk-weight for setting F factor as 1 for the most senior and 2 for the non-senior exposures cannot be fully justified. Credit enhancement should be considered in the formula in cases like high quality mezzanine 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?

As mentioned in Question 12, there is no justification of such an arbitrary large formulaic-driven gap.

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

Mixed pools of SA and IRB exposures would be common due to the two reasons as pointed out in the proposal. When there is insufficient data to generate IRB parameters, the SA approach could be set as default proxy.

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

For mixed pools of SA and IRB exposures, the use of proxy data on SA exposures is recommended for MSFA and CR_{KIRB} applications, as opposed to total prohibition of these applications as proposed.

The industry supports also an alternative of a pro rata basis application in conjunction with the BCRA treatment.

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

Clarification is sought on the requirement that the contractual payments must be unconditional and must not be dependent from the actual performance of the securitised assets. In a lot of the ABS transactions, payoffs are in fact dependent on the performance of the underlying assets.

The defaulted use of final legal maturity is considered inappropriate as it makes an implicit simplifying assumption that the maturities of the underlying assets of the securitisation transaction are the same as the maturity of the securitisation tranche. However, it is common for market participants to set up long-tenor securitisation structures – in order to minimize legal and administrative costs – where the underlying loans have short maturity and are replenished as necessary.

As a better option, the use of weighted average life (WAL) is highly recommended, especially for amortizing transactions. WAL is the primary measurement of tenor widely used by participants in the securitisation market for many years. For certain transactions backed by amortising assets, the final legal maturity could be much longer than the economic life of the transactions. Therefore, the use of final legal maturity could largely overstate the risk exposures and discourage investment in these effectively less risky assets.

As mentioned in answers to Questions 6 and 8 above, the introduction of maturity factor (M) may cause a material distortion in capital requirements for securitisation vis-à-vis the IRB framework for underlying assets. This distortion is particularly pronounced for securitisation of short-dated assets such as working capital and trade finance assets. If maturity factor (M) is not set at WAL of such assets to reflect the lower credit migration risks of the assets, it is believed that banks will find it economically prohibitive to securitise these assets for risk mitigation or capital relief purposes. This will likely reduce available credit capacity, particularly for small and medium-sized businesses that tend to depend on such working capital and trade financing loans. This may have repercussions on global trade and economic growth.

Therefore, the setting maturity factor (M) based on legal maturity of the securitisation tranche does not appropriately and fairly reflect differences in tenor, risks and characteristics of the underlying securitised assets and therefore, renders the revised calibration less risk sensitive, which is contrary to the stated objective of the Proposal.

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.

The proposed 20% floor is set too high and might potentially make bank investors uncompetitive compared to the lesser-regulated shadow banking system. In particular, it is believed that the 20% floor is inappropriately high for certain senior asset-backed securities, especially when compared to equivalent whole loans. By way of evidence, we take the case of Lloyds Banking Group which issues UK Prime RMBS AAA bonds, predominantly from Permanent Master Issuer and Arkle Master Issuer. Lloyds Banking Group also publishes risk weights for its entire mortgage book in its annual “Pillar 3” disclosure document. According to its 2011 Pillar 3 report, the top two-thirds of its mortgage book in terms of quality (£241bn) carried an average risk weight of 4%. Its full mortgage book (£361bn) carried a weighted average risk weight of 16% (which includes high risk and defaulted mortgages).

In addition, from a much referenced FitchRatings’ recent report “Global Structured Finance Losses” published in October 2012 stated that the average total loss on global structured finance tranches between 2000 and 2011 was only 4.9%, of which 1.5% was incurred write-downs and 3.3% was estimated future losses. This implies that senior tranches are not likely to incur large scale losses on a global average basis provided that the most junior tranche would have a thickness greater than 4.9%.

This interpretation though may have ignored in part the loss dispersion. Yet again from the same report, the global average loss was mainly contributed by U.S. RMBS, 99.7% of which was related to transactions issued before 2008. Subsequent betterment from 2008 in aspects of underwriting, structuring techniques, rating methodology, investor due diligence, etc. seem to have resulted in much lower loss exposures.

For Asia-Pacific, the average total loss between 2000 and 2011 was only 0.9% which indicates that a 20% floor imposed on senior Asian tranches is excessively conservative.

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

Refer to Question 17, a risk-weight floor is not a risk sensitive approach and more unfavorable to developing markets.

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

It is inappropriate to assign a higher risk weight to a securitisation exposure than that would be required to hold the underlying exposures directly, or that the effect of credit enhancement is not being considered - regardless of whether the securitised assets are being acquired as an originator, sponsor or investor.

Insensitive risk level distinction may unintentionally discourage asset backed lending, which should in fact at times be less risky for banks to hold, noting certain scenario outcome leading from the proposed revised RBA and MSFA approaches as mentioned earlier of the higher rated tranches.

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

No additional comments than those afore mentioned.

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.

The assumptions used in developing the approaches are individually not unreasonable but their aggregate impact is probably somewhat conservative.

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?

From investor's perspective, ABS backed by diversified retail pool are viewed as "plain vanilla" asset class, which out-performed other securitised assets (auto ABS and prime RMBS in particular) during the global financial crisis. However, pricing on ABS backed by consumer assets are typically tighter than those backed by corporate exposures which seem to illustrate the different perception of risk profiles in the respective pool, hence a different approach may be warranted.

Question 23: How could concerns that securitised retail exposures have high default risk or high correlation be managed?

High default risk and high correlation can be properly managed through credit enhanced structures provided that the effect of such enhancements is recognized by the Committee by fine-tuning a risk differentiating weighting scale.

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

The risk weight of 1250% is based on the assumption of 8% capital ratio requirement. Under Basel 3 regime, the assumption may cause a 1250% risk-weight more punitive than a capital deduction. For instance, the Indian implementation of Basel 3 proposes a 1111% risk weight as a capital deduction equivalent, under a 9% capital ratio assumption. Similarly in other cases under IRB rating based approach applying a >1 scaling factor would result in a risk-weight equivalent effectively larger than a capital deduction. Rectification is required of these legacy scenarios.