NOMURA

15th March 2013

Basel Committee for Banking Supervision
c/o Bank of International Settlements
CH-4002
Basel, Switzerland

Nomura response to the Consultative Document on Revisions to the Basel Securitization Framework

Nomura is pleased to provide responses to Basel Committee on Banking Supervision (BCBS) on the recently proposed consultative document "Revisions to the Basel Securitization Framework" published on 18 December 2012 by the Basel Committee on Banking Supervision. We support the goals identified in the document (which we refer to as the "Proposals" when taken together with the supplementary "Working Paper 22" and "Working Paper 23").

Overview

Nomura fully supports the Committee's objectives to create a securitization framework which is more prudent and risk sensitive, mitigates mechanical reliance on rating agencies and reduces cliff effects. Such a framework which better aligns regulatory capital requirements with the economic risks of securitization exposures would minimize the potential for regulatory arbitrage, improve banks' access to funding, and, in conjunction with other legislation such as risk-retention and due diligence requirements, encourage responsible lending to the real economy. On this latter point, we agree with the Financial Stability Board (FSB) statement in 2010 that *"Re-establishing securitization on a sound basis remains a priority in order to support provision of credit to the real economy and improve banks' access to funding in many jurisdictions."*[1] We also concur with the Joint Forum's recognition of "*the potential benefits of securitization, including its positive effects on credit availability.*"[2]

However, we have concerns that the Proposals, if adopted, may not achieve these goals. First among our concerns is that the approaches may result in competitive imbalances at internationally active banks. Specifically, the consolidated capital treatment of subsidiaries of foreign institutions in a given region may differ significantly from the treatment of international banks native to that region if the foreign regulator adopts a different approach than the local regulator. We believe it is critically important that banks operate in an internationally fair competitive environment, and therefore recommend a framework based on Hierarchy A which allows banks some flexibility in choosing among the approaches rather than being limited to one approach selected by their national regulator. Failure to create the flexibility could likely result in competitive disadvantages that will inhibit global firms from competing across regions.

In addition, we note certain inconsistencies which result from application of the various proposed methodologies, and the overall level of conservatism inherent in the framework. These variations in capital requirements of a single exposure when using different approaches, inconsistencies between the treatment of securitization exposures and their underlying assets, and inconsistencies between

[1] See Report of the Financial Stability Board to G20 Leaders, November 2010.

[2] See Basel Committee on Banking Supervision (BCBS), Joint Forum Report on Asset Securitization Incentives, July 2011. The Joint Forum includes the BCBS, International Organization of Securities Commissions (IOSCO), and International Association of Insurance Supervisors (IAIS).

the results of the approaches and historical experience.[3]

We provide more detail regarding these considerations below. We look forward to working to address these considerations. Nomura is participating in the work conducted by the Global Financial Markets Association (GFMA) on this topic and is supportive of their efforts and recommendations.

Specific Concerns and Responses

1. Choice of Hierarchy and Concern over Competitive Imbalances for Internationally Active Banks (Questions 1, 2)

We have some concern that application of different rules by regulators in different regions will result in global competitive imbalances at internationally active banks. As a result, we favor neither Hierarchy A nor B, but rather a permutation of Hierarchy A which would help mitigate such imbalances. More specifically, we recommend that below the MSFA in Hierarchy A, banks have the ability to choose either the RRBA or the SSFA at a regional level rather than be forced to select one approach for all exposures in all regions. This would allow regulators to respond to regional securitization protocols, it would also allow a fair competitive environment, applied consistently over time and agreed upon with the home regulator.

Our concern over potential competitive imbalances is best illustrated by example. Consider the case in which the regulator in Region "A" adopts the RRBA, but the regulator in Region "B" adopts the SSFA. These approaches often vary widely as we discuss below. As a result, the Region "B" subsidiary of a bank domiciled in Region "A" could be put at a significant competitive advantage or disadvantage in its consolidated capital requirements relative to peers which are domiciled in Region "B".

This is the case in the US market, for example, where regulators are likely to use the SSFA (Simplified Supervisory Formula Approach) to calculate capital charges on securitisations. A sizeable portion of the US non-agency RMBS market consists of senior bonds that could incur modest write-downs and hence have non-investment-grade ratings. However, a substantial portion of these bonds' principal is extremely safe from credit risk even in very harsh economic scenarios and virtually all of them are priced at discounts to par. Thus, these warrant capital requirements which are less than 100% (1250% risk-weight) to reflect the more certain portion of their cash flows. The SSFA reflects this, by taking into account delinquency levels, credit enhancement and tranche thickness in determining capital charges. The RRBA approach does not, however, and may assign such a position a 1250% risk-weight. Thus, unless these approaches for calculating capital charges are aligned, non-US institutions holding US RMBS positions would be at a significant disadvantage relative to their US-based competitors.

Perfect alignment of the various approaches is not feasible, in our view, although we do believe it is important that alignment is improved (as we discuss below). We therefore recommend that regulators be permitted flexibility to permit banks to apply regional approaches rather than being forced to one approach for all securitizations in all regions.[4] This will help reduce potential competitive disadvantages and inefficient allocation of capital.

With respect to the proposed Hierarchies, we prefer to base our recommendation on Hierarchy A (with the adjustment noted above) because we find Hierarchy B to have significant drawbacks that make it less appropriate for use. Among these is the difficulty in objectively defining the term "high-

---

[3] According to Fitch, The results from the new proposals "do not correspond to historical observations from any currently active [structured finance] segment." See *Fitch Capital Requirement Proposals Diverge from Structured Finance Performance*, March 2013.

[4] In the example shown above, our proposal would allow the non-US bank operating in the US to use the SSFA on its US exposures when calculating consolidated capital requirements. The choice would ideally be available to all banks, however we recognize that some jurisdictions (i.e., the US) may not allow the RRBA by law.

quality" (which could awkwardly make the whole framework ratings-based) and, according to our analysis, would result in severe cliff effects for exposures that change to / from "high-quality" status. Additionally, we find the CK_{IRB} and BCRA approaches to be less risk-sensitive. It should not be the case, for example, that a first-loss tranche with a 20% detachment level should get the same risk weight as a 10%-to-20% tranche with the same underlying pool. Furthermore, the factor "F" set to two for non-senior tranches in the BCRA seems arbitrary, and can lead to undesirable inconsistencies. Under the BCRA, the combined capital requirement on a 10%-20% tranche and a 20%-100% tranche could be double the capital requirement of a 10%-100% tranche with the same underlying.

2. Clarity and Consistency of Application to Trading Books

We believe it is important to promptly clarify the capital treatment of securitization trading book positions. The proposal is somewhat ambiguous as to whether or not the new framework is to apply to securitization exposures in both trading books and banking books. The Committee noted that they were "not proposing specific revisions to the trading book rules at this stage" given that the fundamental review of trading book (FRTB) rules is under way. However, the 2009 revisions to the current Basel Framework requires banks to use banking book risk-weights for trading book exposures. Therefore, while we believe the new proposal is not intended for trading book application, the issue remains somewhat unclear. We request that the Committee clarify the applicability of the new framework to trading books as soon as practicable.

If it is the case that the Proposals are not intended for trading books, we would be concerned that new banking book rules might be adopted before the FRTB is completed. This would have at least two potentially undesirable effects. It would leave trading book capital treatment subject to the very issues which the BCBS is trying to address in the Proposals, including over-reliance on CRA ratings, cliff effects, and capital charges which are too low on some exposures (e.g., highly-rated subordinates) but too high on others (e.g., low-rated seniors). It would result in dramatically different capital requirements for single exposures depending on which type of book they are held, creating potential arbitrage incentives for institutions which have both trading and banking books. We therefore ask the BCBS to implement new banking book and trading book frameworks simultaneously, or if the FRTB is unlikely to be completed soon, apply the new banking book framework to trading books in the interim.

3. Applicability of the MSFA

The proposed hierarchies are reliant on banks' ability to gain IRB approval for their securitized exposures. The misassumption here is that only originators can use the MSFA, a result which we believe should be reconsidered. IRB approval (i.e., approval to use internal model PD and LGD estimates to calculate capital requirements) has typically only been granted to originators, with the assumption that these entities were the only organizations positioned to assess loan level performance and expectations. However, the premise that asset originators are the only institutions able to accurately calculate PD and LGD is no longer accurate in many cases. For example, investors in the US mortgage market have a wealth of current and historical loan level data on securitized loans, with often as much information as some originators have. This data includes payment history, borrower profile, loan valuation, and many other data fields, and typically goes back to the issuance date of the securitization. Although the history of such data in Europe is more limited, many originators have been providing similar information in recent years, some going as far back as 2007. We therefore believe many banks (as investors) have the capacity in certain sectors to calculate PD and LGD on investments with models similar to those of IRB-approved banks. Given this fact, and the prominence of the MSFA in the Proposals, we believe regulators should permit sophisticated investors to use the MSFA based on PD and LGD estimates from regulator-approved models on underlying assets they did not originate. We propose that the Committee provide details on relevant model and data requirements it sees as reasonable for banks to have in order to use the MFSA for securitized exposures originated by others.

4. Risk-weight Caps and Maximum Capital Charge for SA Banks (Question 19)

We support the Committee's decision to allow risk-weight caps to be applied to senior Standard Approach (SA) exposures regardless of whether or not the exposure is rated. This better aligns risk-weights with economic risk, especially for banks acting as investors. In our view, the "Maximum capital charge (overall cap)" for securitization positions should also apply to SA banks as investors rather than be limited to originators/sponsors. We understand that the principle behind the overall cap is that banks should not hold more capital against a securitization position than they would if they held all the underlying exposures in unsecuritized form. This cap is particularly important for banks acting as investors for two reasons:

a. Their ability to calculate the IRB capital charges on the securitized loans may be limited either by data or lack of IRB approval for certain exposures, and
b. The resulting capital charges under the RRBA for non-senior securitization positions are clearly excessive relative to the capital required for underlying loans, as discussed below.

An example of this inconsistent treatment for SA banks is below, which is based on a typical seasoned RMBS securitization. Under the RRBA, the capital charge on the Class C mezzanine tranche exceeds by more than 50% the capital the bank would have to hold had they held *all* the loans in the pool directly (4.8 vs. 3.1). The junior-most tranche capital charge is 200% of the underlying requirement (6.2 vs. 3.1). These are excessive, when considering the mezzanine exposure benefit from the loss protection provided by credit enhancement (as well as excess interest not recognized in the proposed approaches). This anomaly also arises with other asset classes, and when using other approaches, such as the SSFA. We therefore ask the committee consider applying the principle behind the overall cap to all banks, which would result in the capital charges shown on the right of the table below. It is important to note that the resulting capital requirements are still substantial (e.g., the risk-weights on affected exposures are 350% or higher), and risk-sensitive, since the underlying capital charges would increase if pool performance deteriorates.

Proposed MSFA, RRBA & SSFA Capital Charges on Sample European RMBS Securitization

Bond	Balance	Enhance-ment	Rating	**MSFA (IRB bank)**	**RRBA (SA bank)**	**SSFA (SA bank)**	RRBA (w/ Overall Cap)	SSFA (w/ Overall Cap)
A Senior	63	36%	AAA	**1.0**	**2.0**	**1.0**	2.0	1.0
B Mezz	9	27%	AA	**0.1**	**2.0**	**0.5**	2.0	0.5
M Mezz	9	18%	A	**0.1**	**2.7**	**1.3**	2.7	1.3
C Mezz	11	6%	BBB	**2.3**	**4.8**	**5.8**	3.1	3.1
D Equity	6	0%	NR	**2.8**	**6.2**	**6.3**	3.1	3.1
Total	100			**6.4**	**17.8**	**14.9**	13.0	9.0
Total Capital on Underlying Mortgages (SA)				**n/a**	**3.1**	**3.1**	3.1	3.1
Total Capital on Underlying Mortgages (IRB)				**2.8**	**2.8**	**2.8**	2.8	2.8

Source: Nomura, BCBS. Equity portion represents reserve fund (typically retained by sponsor). SA assumes 35% risk weight on underlying performing loans and 100% on delinquent loans. IRB and MSFA Calculations based on PD = 1.0%, LGD = 25%. MSFA figures reflect IRB overall cap, but other approaches are SA-based and reflect senior risk-weight caps only. Hierarchy B uses the BCRA for non-senior tranches. Bond balances are rounded.

5. Consistency of Securitization Treatment with Underlying Exposures (Questions 6, 8, 10)

We have some concern that the overall capital required from holding securitization positions can be several times that of the capital required on the underlying loans if they were held directly. This anomaly exists across the frameworks, across underlying asset classes (SME loans, credit cards, mortgages), and is evident across a wide variety of capital structures. As seen below, the "sum of the parts" capital charges for the generic RMBS securitization under the potential Hierarchies and approaches for SA banks are between 4.8 and 5.7 times greater than the Standard Approach capital charges on the underlying mortgages themselves. They are 5.4 to 6.5 times greater than the IRB capital charges. The MSFA is also high relative to the IRB requirements on the underlying, at 2.3 times.

These dramatic differences between securitized and unsecuritized loan capital charges could render large parts of the securitization market uneconomic. This could have negative "knock-on" effects to the real economy, as banks would have difficulty accessing funding and managing risks (credit, prepayment or other) on small-to-medium enterprise loans, consumer loans and mortgages. The capital framework for securitization should better align capital charges with those of the underlying loans and better reflect the risks of the exposures. We recognize that it may be prudent to have the "sum-of-the-parts" capital charges for an entire securitization exceed the charges on the underlying loans when held directly, but recommend that a pool's capital charges post-securitization should not typically exceed its requirements pre-securitization by such substantial margins.[5]

Proposed Capital Charges Under MSFA and Hierarchies A & B on Sample European RMBS Securitization

Bond	Balance	Enhancement	Rating	MSFA (IRB)	Hierarchy A w/ RRBA	Hierarchy A w/ SSFA	Hierarchy B w/ RRBA	Hierarchy B w/ SSFA
A Senior	64	36%	AAA	1.0	2.0	1.0	2.0	1.0
B Mezz	9	27%	AA	0.1	2.0	0.5	1.6	1.6
M Mezz	9	18%	A	0.1	2.7	1.3	2.1	2.1
C Mezz	11	6%	BBB	2.3	4.8	5.8	4.0	4.0
D Equity	6	0%	NR	2.8	6.2	6.3	6.2	6.2
Total	**100**			**6.4**	**17.8**	**14.9**	**15.9**	**15.0**
Total Capital on Underlying Mortgages (SA)				**n/a**	**3.1**	**3.1**	**3.1**	**3.1**
Required Capital as % of Underlying (SA)				**n/a**	**572%**	**478%**	**512%**	**481%**
Total Capital on Underlying Mortgages (IRB)				**2.8**	**2.8**	**2.8**	**2.8**	**2.8**
Required Capital as % of Underlying (IRB)				**228%**	**646%**	**540%**	**578%**	**543%**

Source: Nomura, BCBS. Equity portion represents reserve fund (typically retained by sponsor). SA assumes 35% risk weight on underlying performing loans and 100% on delinquent loans. IRB and MSFA Calculations based on PD = 1.0%, LGD = 25%. MSFA figures reflect IRB overall cap, but other approaches are SA-based and reflect senior risk-weight caps only. Hierarchy B uses the BCRA for non-senior tranches. Bond balances are rounded.

6. Consistency of Approaches Under the Proposals (Question 10)

While we recognize the difficulty in ensuring relatively similar capital treatment results from the various approaches for exposures across asset types and across the capital structure, we are concerned that the approaches vary so sharply on generic securitization exposures. As shown above, RRBA requirement is double that under the SSFA for the senior exposure, four times as large for the Class B exposure, but 20% smaller for the Class C exposure. On new-issue securitizations, the variation is often considerably higher. Additionally, there is a large variation between the MSFA and the SSFA. SSFA capital requirements can be up to 5 times that of the MSFA for a particular tranche (e.g., for Class B), and are 2.3 times those of the MSFA when considering the entire capital structure (14.9 vs. 6.4). Our analysis suggests these variations are quite common.

We understand that the Committee sought to roughly calibrate the SSFA to the MSFA, and also seeks to use the results of the Quantitative Impact Study (QIS) to ensure that the SSFA results are broadly aligned with those of the RRBA. Our analysis of typical securitization exposures, however, suggests that both the SSFA and the RRBA may be calibrated too conservatively relative to the MSFA. Therefore, we ask the committee to consider using the QIS results to recalibrate both the SSFA and the RRBA to ensure they are both broadly aligned with the MSFA. Not doing so would likely result in widely divergent capital charges, and in particular put banks at a significant competitive disadvantage when using the Standard Approach, perhaps to the point of precluding them from investing in securitizations altogether.

7. Incorporation of Maturity and Mark-to-Market Risk in the Framework

One apparent reason the capital requirements seem excessive compared to those on the underlying loans is that the proposed capital charges seem intended to reflect market risk (i.e., mark-to-market volatility) for banking book exposures in addition to credit risk. This change seems related to the inclusion of maturity as a risk driver in securitization. We are concerned about the implication that

[5] We note that application of the Overall Cap to all positions will significantly change the disparity between pre- and post-securitization capital requirements. An example can be seen in the table in section 4.

securitization capital charges should reflect mark-to-market risk. This appears to be a fundamental change in the framework and difficult to reconcile with the treatment of underlying exposures and other fixed income securities under the Basel III framework.

We also believe that maturity, particularly as defined under the proposal, is generally not a very relevant credit risk metric for securitizations, and it adds an unnecessary layer of complexity to the proposed approaches, especially the RRBA (Question 16). The vast majority of securitized loans have contractual cash flows well in excess of 5 years, and therefore the vast majority of securitization exposures would be subject to the 5-year cap. Furthermore, maturity and contractual cash flows are already considered in rating agency analyses, so it may be overly conservative to use it again as a factor in the RRBA (particularly when defined "to worst"). We therefore recommend the Committee refine the approaches to exclude maturity and "mark-to-market" risk as a factor in the proposed approaches.

8. Floor on Capital Charges (Question 17)

We believe the 20% floor is unjustifiably high for senior exposures, and lower risk-weights may be appropriate for highly-enhanced senior exposures in low-risk asset classes. In fact, the collateral performance of the vast majority of securitizations outside those with exposure to US non-agency RMBS market has been very strong even throughout the recent financial crisis. Realized losses were less than 15bp per year during the crisis in US ABS, US CMBS, European RMBS, European ABS and European CMBS.[6] Lifetime expected losses are also low enough to justify a floor below 20% (as shown below).[7] Furthermore, many IRB banks have mortgage exposures which attract risk-weights of less than 20%. From this perspective, the 20% floor seems unjustified.

Finally, flooring risk-weights on senior securitization exposures at 20% may actually make the capital requirements less risk-sensitive, since a large proportion of senior exposures would be set at the floor. To the extent the 20% risk-weight is unjustified by economic risk of an exposure, it could give banks (as investors) incentives to hold more junior securities instead of senior ones, and also discourage banks (as originators) from using securitization as a risk-mitigation tool.

Total Realized & Expected Lifetime Losses on AAA RMBS, CMBS and ABS During the Credit Crisis

Sector	US RMBS	US ABS	US CMBS	EMEA RMBS	EMEA ABS	EMEA CMBS
Total Loss (4y Realised + Future Expected)	6.5%	0.2%	0.3%	0.2%	0.0%	0.7%

Source: Fitch. Note these are totals, not annualized figures. Data shows actual performance from July 2007 to July 2011, plus total expected future losses as a percent of outstanding balances as of July 2007. EMEA is Europe, Middle East and Africa, but largely reflects European exposures.

We believe that if the floor is intended to be a measure of residual/model risk, then it may be appropriate to link the floor to the risk of the underlying portfolio. We therefore recommend the Committee consider a "variable floor" based on the risk-weights of the underlying loans. For example, the floor could be set at 20% of the average risk-weight of the securitized pool, with an absolute minimum of 10% to account for residual/model risk (i.e., 10% for 50% or lower risk-weight loans, 20% for 100% risk-weight loans, and 30% for 150% risk-weight loans). This would also allow more appropriate treatment for low-risk senior securitized exposures and make the risk-weights more risk-sensitive.

Summary

---

[6] See Fitch's *U.S. Structured Finance Losses, The Credit Crisis Four Years On, July 2011,* and *EMEA Structured Finance Losses, The Credit Crisis Four Years On*, August 2011.

[7] While one may argue that historical performance prior to the crisis was also strong, we note that regulatory changes including risk-retention rules, underwriting requirements and due diligence requirements have greatly reduced the risk of abuse or misaligned interests via securitization or other risk-transfer tools.

Nomura appreciates the opportunity to respond to the Committee on its consultative document "Revision to the Basel Securitisation Framework." We recognise the many challenges in developing a single comprehensive framework which is appropriately conservative and meets the Committee's goals, which we support. At the same time, we believe it is critically important that the framework

1. Allow for a fair competitive environment for banks across the globe, and

2. Is not so conservatively calibrated or inconsistent that it prevents banks from using securitisation for funding and risk-management purposes.

Ensuring these goals are met will help ensure that banks, investors and consumers will realise the benefits a healthy securitisation market can provide. A more flexible regime, which does not require banks to select one approach for all securitisations in all regions could help mitigate the risk of competitive imbalances. Recalibrating the approaches with one another and with the treatment of underlying exposures for typical securitisation structures would help ensure securitisation remains a viable funding tool for banks. It would also allow them to use securitisation in its critically important function of risk mitigation. Together, these would help improve the flow of credit to the real economy.

It is, of course, easier to point out issues with the proposed framework than it is to solve all of them simultaneously. We will therefore continue to work with industry organisations such as the GFMA to develop more specific recommendations, which require more time given the complexity of these issues. We hope that the Committee will allow for another consultation period once the QIS and current round of responses are analysed.

We greatly appreciate your consideration of the views set forth in this letter, and we would be pleased to have the opportunity to discuss these matters further with you or with any member of the Committee. Please feel free to contact either of us.

Sincerely,

David Covey
Securitized Products Managing Director
Tel: +44 20 710 30220

Scott Lechner
Securitized Products Managing Director
Tel: +1 212 667 1130