Annex

Saudi Banks Comments on
BCBS Consultative Document entitled
"Revision to the Basel Securitization Framework"

Bank # 1

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?

Bank comment:

We propose to give consideration to the state of ITinfrastructure and data availability in banks as well as the level of complexity of implementing the revised securitization framework across banks in this jurisdiction. In our opinion, Alternative A presents greater benefits relative to its drawbacks (data availability and framework complexity) in terms of best addressing the shortcomings identified with the current framework. Specifically, Alternative A is more risk sensitive. Moreover, it encourages banks to do internal assessments of risk rather than mechanistically relying on external ratings and reduces cliff effects. While MSFA[1] achieves the objectives of making capital requirements more prudent and risk sensitive, requiring an investor bank to calculate the IRB capital requirement for the underlying pool (K_{IRB}) is subject to data availability and might not be practical.

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?

Bank comment:

We agree with the proposal made by the Committee that the national supervisor should allow only one approach to be used within its jurisdiction to create a level playing field and avoid any regulatory arbitrage possible.

[1]MSFA: Modified Supervisory Approach

3: As regards Alternative B, which methods could a bank use to conclude that a securitization 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?

Bank comment:

We believe that the determination of high-quality securitization exposure based on the existing IRB securitization framework to treat a securitization exposure "as a senior tranche if it is effectively backed or secured by a first claim on the entire amount of the assets in the underlying securitized pool" would be sufficient. If this method is used across banks and countries it would likely result in a consistent capital charge.

While we agree with the proposal that determination of "high-quality" should be based on both external ratings and the bank's own assessment of credit risk, we see there is no better practical alternative method to external ratings.

4: Are there alternative hierarchies or <u>revisions to the two proposed (or a combination of both) that the committee should consider</u>?

Bank comment:

While there may be other alternative hierarchies, we believe that the two proposed hierarchies address the objectives of making capital more prudent and risk sensitive, reducing mechanistic reliance on external ratings, and reducing cliff effects.

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 <u>reducing idiosyncratic, rating agencies' modeling risk with the costs of using two ratings and/or whether exceptions to this treatment should be permitted.</u>

Bank comment:

<u>While the cost of using two external ratings would be negligible and would be greatly outweighed by the benefits, we think that exception to use one external rating from an eligible external credit assessment institution should be permitted</u>.

6: Is the RBA[1] appropriately calibrated and formulated? Should other risk drivers be incorporated?

Bank comment:

Considering that the maturity parameter used in the MSFA and revised RBA is an important driver of capital requirements, we propose to consider making the increment of risk weights across the maturities more gradual; in effect, making the risk weights across the maturities less steep.

In addition to the risk drivers considered in the revised RBA (seniority, thickness, and maturity of the tranche), we propose to consider in Alternative A the credit enhancement a tranche receives from its subordinate tranches as the subordinated tranches function as protective layers of the more senior tranches.

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?

Bank comment:

We suggest considering differentiating the requirements to use the MSFA between an originating bank and an investor bank. We propose to restrict the use of the MSFA only to originating banks using the IRB approach for the underlying assets of the securitized exposure. However, for investor banks this restriction should not apply due to, in our view, the possibility that data availability, such as loan-level IRB estimates of the underlying assets, might be difficult to obtain. In addition, this would potentially create a regulatory burden and reduce the investor banks risk appetite.

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?

Bank comment:

We propose to incorporate as a risk driver the credit enhancement a tranche receives from its subordinate tranches.

[1] RBA: Risk Based Approach

With regard to the calibration of tau and omega, we believe that only through having parallel runs and analyzing the performance of the portfolios under MSFA could this be determined.

9: <u>Is it prudent to allow the use of the MSFA by banks making use of the foundation IRB approach (ie not calculating internal estimates of the underlying loans' LGD)?</u>

Bank comment:

In view of the fact that banks applying the Foundation IRB approach must use supervisory estimates for LGDs, it may not be practical for the national supervisor to provide granular LGDs for the underlying asset of the securitized exposure in order to generate the capital requirements.

10: Is the SSFA[1] (particularly the constant term p) appropriately calibrated? Please provide justification and evidence, to the extent possible, for alternative appropriate levels of calibration?

Bank comment:

We believe that only through having parallel runs and analyzing the performance of the portfolios under SSFA could the appropriateness of the calibration be determined. However, we note that unless justified by data, the term *p* should remain to be set to 1.5.

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

Bank comment:

<u>We agree with the formulated SSFA methodology and we don't think other risk drivers need to be incorporated at this stage</u>.

12: Has the BCRA[2] been appropriately calibrated and formulated?

Bank comment:

We believe that only through having parallel runs and analyzing the performance of the portfolios under BCRA could the appropriateness of the calibration be determined.

[1]SSFA: Simplified Supervisory Framework Approach

[2]BCRA: Backstop Concentration Ratio Approach

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?

Bank comment:

In the revised securitization framework the multiplier F is defined only for senior and non-senior securitization exposure, we suggest that the degree of conservatism set using the multiplier F should differentiate among three levels of securitization exposure junior, mezzanine, and senior. Having three levels will also help alleviate the cliff effect.

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

Bank comment:

In our opinion, mixed pools are not prevalent. Based on this, we agree with the Committee's proposal to use the BCRA for mixed pools and that should generally prove to be relatively conservative.

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

Bank comment:

We agree with the Committee's proposal to use the BCRA for mixed pools and that should generally prove to be relatively conservative.

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

Bank comment:

We agree that the definition of maturity which is in line with definition currently used in the Basel capital framework is appropriate with the Committee's objectives.

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.

Bank comment:

We agree with the proposed 20% risk-weight floor for long-term ratings and agree <u>that it would mitigate the model risk associated with external ratings. However, we propose to lower the risk-weight floor for short-term exposure.</u>

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

Bank comment:

<u>We propose to lower the risk-weight floor for short-term securitization exposure.</u>

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

Bank comment:

We agree with the proposed caps and their interactions with the proposed floor risk-weight. However, we would like to note that for banks investing in securitization tranches, obtaining the risk weight cap applicable to the underlying exposure might be difficult for some banks because it would entail capturing detailed information.

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

Bank comment:

While we have no new approaches to recommend, we believe that some of the proposed approaches may be operationally challenging to implement.

21: Are the assumptions used in developing and calibrating the approaches discussed above appropriate in view of the Committee's stated objectives? <u>Please provide empirical justification for alternative assumptions to those noted above</u>.

Bank comment:

In the absence of the forthcoming technical note on the detailed calibration of the revised RBA and MSFA, it is difficult to comment on the calibration of the proposed approaches. <u>However, considering that the maturity parameter used in the MSFA and revised RBA is an important driver of capital requirements, we propose to consider making the increment of risk weights across the maturities more gradual. Since both the revised RBA and MSFA have been developed using the same set of underlying assumptions</u>, our suggestion to reconsider the increment of risk weights across the maturities applied to both approaches. Also, we propose to consider the credit enhancement a tranche receives from its subordinate tranches as the subordinated tranches function as protective layers of the more senior tranches.

22: Is the proposed treatment of retail securitizations using the same approaches as for corporate securitizations 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?

Bank comment:

We share the same concern with the Committee that the proposed treatment of retail securitization using the same approaches as for corporate securitization, in particular the incorporation of an explicit maturity adjustment within the MSFA and revised RBA has the potential to over-estimate, or double-count, the effect of maturity for retail exposures.

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

Bank comment:

Generally speaking, we believe that retail exposures may have higher default risk than corporate exposures but lower correlations. This lower correlation mitigates the risk of higher default rates among retail exposures. In our view the benefit of lower correlation should continue to be accounted for in the capital formula.

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

Bank comment:

We believe that only through having parallel runs and analyzing the performance of the portfolios under the revised framework could the appropriateness of the calibration be determined.

Bank# 2

From the Bank's perspective, we shall apply Simplified Supervisory Formula (SSF) as and when we decide to use securitization framework. We find that we will be required to determine the risk weight of a securitization exposure using a formula based on the weighted average capital charge determined under the Standardized approach for the underlying exposures, the ratio of delinquent underlying exposures to their ending balance, the attachment point of the securitization exposure (at which losses would first be allocated to the exposure), its detachment point (at which the exposure would be a total loss), and a supervisory calibration parameter (p).

We believe that the proposed framework will be more transparent to the banks from capital calculations perspective due to the following:

a. A bank's capital requirement for a retained securitization exposure will not be higher than the amount of capital it would be required to maintain if it held all the underlying exposure directly.

b. For a senior securitization exposure, a bank could apply a look through approach to determine the maximum risk weight based on the weighted average risk weight of the underlying exposures. While this look-through exists in the Basel II Standardized Approach under the Proposal it would apply to rated as well as unrated securitization exposures, and whether the risk weights of the underlying exposures were calculated under the IRB or the Standardized Approach.

c. A bank that used the Standardized Approach to determine risk weights of underlying exposures could use inferred ratings (credit ratings of a junior rated tranche) to determine the risk weight of a more senior unrated securitization exposure.

d. An originator would no longer be required (as under the Basel II Standardized Approach) in all cases to deduct below-investment-grade retained exposures.

From bank perspective, we feel comfortable with the proposed amendments and should be in a position to implement the guidelines as and when issued by the regulator.

Finally, we believe that the proposed document needs to address the structural uniqueness of the national economy which has traditional as well as Islamic products which appears to have not been addressed in this revision. Therefore, the proposed framework may be validated by the quantitative impact study (QIS) for banks securitization business.

Bank # 3

A review has been undertaken on the proposed revisions.

The background to these measures is clear as the proposed changes are the latest effort by the Basel Committee (BCBS) to address shortcomings in its global capital rules exposed by the 2008 financial crisis, in particular the reliance on flawed external credit ratings for securities linked to U.S. subprime mortgages.

We appreciate that these changes are at a high level, however, there remain a number of issues to be clarified by the BCBS:

A number of the inputs for the proposed new formulae appear arbitraryor simply not explained. The parameters to be included in calculating capital requirement (K) per unit of exposures (referencedas part of the revised RBA parameters) do not appear to be derived orexplained; the supervisory adjustment factor (P) for the SSFA isproposed to be higher than that used in the US; Factor (F), amultiplier used in the application of the BCRA, is set at a constant2 for all tranches below the most senior one.

Despite the stated aims of discouraging over-reliance on ratings, abank would still require at least two eligible credit ratings inorder to use the revised RBA.

Despite recognizing maturity as a factor in assessing capital atrisk, the proposal for minimum capital is the same for both long termand short term exposures.

There is no immediate impact to bank of these proposals as we are currently not engaged in securitisation activity. However, in the longer term as we intend to look at securitisations more closely in line with our strategy to grow the home loans proposition and potentially financing to the auto sector, the perceived effect of the final rules will need to be assessed as the impact on investors, deal structuring and capital in this sector is likely to be significant, including the way in which deals are sized and tranched and credit enhancement is assessed for term deals and asset backed commercial paper deals generally.
Accordingly, institutions will take time to adjust, while other investment and funding options may seem relatively more attractive in the interim. To the extent that the changes reduce the capacity of banks to originate and invest in securitised products, they may provide further impetus for non-securitised capital markets products and the non-bank lending sector.

Bank # 4

The proposals contained in this paper are very comprehensive and technical and will clearly be very significant to the securitization markets around the world, particularly where securitization activity is mature and well developed.

In looking at the proposals we believe it is likely that there will be significant further discussions/arguments from the major industry players regarding the two alternative hierarchies being put forward by the Committee.

Comments are being sought by the Committee on technical formulas/ calibrations being proposed and whether they are appropriate. This will no doubt trigger differing responses from parts of the market where historical levels of defaults have been very low.

Given that the development of any securitization market in most countries is at best at its very early stages, the relevance of these proposals to the banks is limited for the time being but will of course have to be monitored going forward.

We would also add that from the prospective of Islamic banks, securitisation requires additional documentation and compliance to the principals of Shariah that should be considered in future guidance notes. This will provide assistance and some form of standardisation to the Global Islamic Financial Institutions who are significantly expanding their activities.