ABI

ASSOCIAZIONE BANCARIA ITALIANA

The Italian banking industry's observations on the Basel Committee's "Second Working Paper on Securitisation"

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ABI has formed a special interbank working group to examine the Basel Committee's recent working paper (28 October) on the prudential treatment of classic and synthetic securitisation operations under the standardised and internal ratings approaches to supervision. The ABI committee's observations on the new proposal for a regulation are set forth below.

Yet, primarily Italian banks wish to stress the need for a clear cut definition of securitisation, taking into account that such definition should allow banks "to look to the economic substance of a transaction rather than its legal form"[1].

1. The "clean up" and "time call" clauses[2]

Italian banks are not convinced of the advisability of penalizing the originator bank (a capital ratio equal that on the underlying asset portfolio as if the securitisation had not occurred) in cases of (i) clauses that enable the originator to redeem the asset backed securities in advance and repurchase the securitised assets if the residual portfolio is more than 10 percent of the original value and/or (ii) when such clauses permit the redemption of securities deriving from the securitisation of non-performing loans.

It is unclear, first of all, by what criterion the 10 percent threshold has been set. In fact, the quantification of this limit appears to be the fruit of a market practice rather than the outcome of specific tests demonstrating effectively that below that percentage the exercise of the call does not constitute a credit enhancement but a way of cutting costs in the closing stages of the operation.

Second, it is hard to apply the principle[3] that in order to avoid the penalty the clause must be exercised only when the costs of servicing the outstanding securities are greater than the benefits of servicing the underlying credit exposures, because the assessment of these costs and benefits is not always possible for banks, so that it may be feasable to adopt such principle as an objective reference criterion.

Further, we do not fully agree with the assumption made in point (ii), insofar as even in the case of transaction regarding performing assets some bad loans may always arise, but this does not invalidate the overall quality of the residual portfolio. The regulation might instead set a threshold of materiality to permit capital relief also for portfolios that contain some non-performing assets. The national supervisory authorities might well be assigned to evaluate, case by case, the degree of risk implicit in such clauses. For purposes of comparison, it is helpful to recall that the new Capital Adequacy Directive draft (CAD 3) does not expressly prohibit the repurchase of non-performing assets but requires that they not be bought back at "above market price".

The Basel Committee's proposed rule should also consider the case in which call options are not exercised by the originator. Under the present proposal, a capital requirement equal to that for the securitised portfolio would continue to apply. For such situations, one could well envisage capital relief for the originator bank (if the option were not exercised) for the remaining duration of the securitisation.

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[1] Cfr. *Second Working Paper on Securitisation*, par. B, pag.2.
[2] "Time calls" are European-style calls that can be exercised on set dates. *Second Working Paper on Securitisation*, Pillar II, par. 13, p. 40.
[3] *Second Working Paper*, par. 506, p. 22.

The application of the proposed rules could also generate significant distortions in the amount of capital required at system level. The existence of call clauses, in fact, could result in the application of a 1:1 capital requirement on both the originator and the investors in junior tranches if not otherwise ruled (i.e., the regulator could state that should 1:1 capital requirement be applied to the originator, junior tranche investors would be free of relevant capital charge).

Italian banks appreciate the idea of treating time calls under the second pillar, so that transactions concluded under such clauses can be evaluated case by case by supervisory authorities. This avoids a generalized penalty in the treatment of transactions allowing for early redemption of the sort under discussion here (as happens, by contrast, under clean up call clauses).

2. Early amortisation clauses

On the basis of the Italian experience, the minimum excess spread required by the Basel Committee for a bank to enjoy a conversion factor (CCF) of 0% (that is, the excess spread is more than 450 basis points) is too high. The standard on which this threshold was set appears to derive from statistical analyses on the US market, which are not necessarily in line with European condition. We thus request further study of this question, leaving open the possibility for Italian and other European banks to gather the necessary statistical evidence.

3. Eligible liquidity facilities

The treatment of providers of liquidity[4] is too severe, and the Committee's requirements for eligibility of credit lines are too strict. Moreover, the Italian banking community feels the need for further clarification of the definition of "market disruption", i.e. of those market situations in which a 0% or 20% CCF applies, depending on whether the standardised or internal ratings based approach is used.

4. Standardised approach

Italian banks continue to harbour doubts, in terms of risk management, over the difference in treatment, for equal ratings lower than BBB-, of asset-backed securities in the investor banks'

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[4] *Second Working Paper*, par. 529, p. 27. In order to be considered "eligible liquidity facilities" these exposures must meet the following requirements:

- The facility must clearly identify and limit the cases in which it can be drawn on. Specifically, it must not be used for credit support, to cover losses (e.g., purchase of assets above fair value) or serve as permanent funding instruments of the securitisation.
- Drawing on the facility (e.g., assets purchased under a purchase agreement or loans made under a lending agreement) must not be subordinated to investors' interests, and commissions for use of the facility must not be subordinated or subject to deferral or rescission.
- The facility must not be drawn on after the programme of credit enhancement from which the facility derives is terminated.
- The facility must include an asset quality test that prevents it from being utilized for the coverage of defaulted loan exposures.
- The facility must include a clause reducing the amount that may be drawn when the average quality of the asset pool is below investment grade.

If these requirements are met, the bank providing the credit lines applies a CCF of 20% to the amount of the eligible liquidity facilities with maturity of no more than 12 months, of 50% to longer maturities, and of 0% if the facility is available only in the case of a market disruption event (under the standardised approach). In the supervisory formula approach, in case of market disruption the CCF = 20%. If the eligible facility has an external rating, the RBA approach and a CCF of 100% apply.

portfolios by comparison with corporate bonds. They further observe that the capital ratios envisaged in the Second Working Paper for this category of ABS are still more penalizing than those envisaged in the January 2001 consultation document (350% now instead of 150%).

As for the application of the look-through approach for super senior unrated tranches, Italian banks feel that the application of the average risk weight of the underlying exposures represents a severe penalty, where normally such tranches have greater seniority than AAA-rated tranches. In this case the rule would entail a disincentive for a bank using the standardised approach to acquire a super senior tranche. It should also be noticed that the actual risk of the super senior tranche is really enclosed in the AAA tranche, since the splitting of the 2 tranches above is only carried out by the originator bank for mere commercial purposes.

Finally, we think it is advisable to set a cap on the capital requirement under the standardised approach as well as under the internal ratings based approach (supervisory formula approach).[5]

5. Internal Rating Approach

5.1 Rating Based Approach

Italian banks appreciate the approach proposed, which consists in calculating the capital charges on ABS also for the investing banks that use the IRB approach but lack the data needed to assess the quality of the underlying assets in-house.

Nevertheless, some concern is raised over the introduction of coefficients of granularity (N) and density of high-rated asset classes (Q) in order to calculate the capital ratios under the rating based approach. For these values should already be taken into account in the rating assigned by the ECAIs. Introducing them into the calculation of the capital ratios would entail double-counting of the same elements of evaluation.

5.2 Supervisory Formula Approach

The idea of setting a cap on capital held equal to K_{IRB} (i.e., the capital charge on the underlying asset portfolio if it were not securitised) is certainly reasonable. Otherwise, in fact, we could have situations in which an originator bank that retained all the ABS issued in a securitisation would have a higher capital charge than if the same asset pool had not been securitised. This would be a disincentive to securitisation and would thus conflict with the general principles of the proposed regulations.

As to the recognition of risk mitigation techniques under the IRB approach, Italian banks do not agree with the proposal of restricting eligibility to guarantees (personal guarantees, collateral, and credit derivatives) that meet the requirements laid down in the standardised approach. They request that consideration be given also to guarantee instruments to reduce the risk weight of the tranche retained in the portfolio and not only of the requirement for the securitised pool (K_{IRB}).

6. Operational requirements for prudential treatment of securitisations

One of the minimum requirements for recognition of a securitisation as "synthetic", in the Working Paper, is a prohibition on any clauses which, below a "significant" threshold of materiality, limit the credit protection and/or transfer of credit risk.[6]

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[5] *Second Working Paper,* par. 565, p. 32.

Here, the Italian banking community considers that clarification is necessary concerning the effective quantification of the "significant materiality threshold". Also, Italian banks consider that in any case the risk transference of the portion above the threshold should be recognized. As contracts with ISDA documentation generally indicate thresholds for failure to pay and in the event of restructuring, Italian banks ask whether these thresholds are included under the concept of "significant materiality" thresholds.

[6] *Second Working Paper*, par. 505, p. 22. "Clauses that materially limit the credit protection or credit risk transference (e.g. significant materiality thresholds below which credit protection is deemed not to be triggered even if a credit event occurs or those that allow for the termination of the protection due to deterioration in the credit quality of the underlying credit exposures").