



Rebuilding Basel

'Sweeping' capital requirement changes under consideration

The Basel Committee sought and received feedback on a consultative paper launched late last year (SCI 19 December 2012). Market participants voiced concerns over the proposals and they are now expected to be amended in advance of a second consultation later this year.

"Relative to the existing framework, the changes proposed by the Basel Committee are quite sweeping. They appear to have sought out opinions on as wide a range of questions as possible as a way to encourage feedback and gauge the market's reaction," says Stephen Day, partner at Cadwalader, Wickersham & Taft.

He adds: "People would have liked more time to consider the proposals because nobody wants such fundamental reforms to be rushed. The hope from people I have spoken to is that before this comes into force it will be put out for discussion again."

The current securitisation framework has two approaches – the standardised approach (SA) and internal ratings-based (IRB) approach. The hierarchies of each require a ratings-based approach.

One of the most significant proposed changes is a move away from a ratings-based approach. Instead, the Committee is proposing a combination of approaches and – although a revised ratings-based approach could be used in some circumstances – the intention is to decrease reliance on ratings.

Merryn Craske, Cadwalader senior associate, says: "It is a big change for the market to get used to and raises the question of how to design a framework with approaches which are not based on ratings that remains simple and still works from a practical perspective, while being appropriately risk-sensitive."

The Committee has proposed two replacement hierarchies – Alternative A and Alternative B. Alternative A would use a modified version of SFA, but more controversially Alternative B would require a bank to differentiate between senior high quality securitisation exposures and others.

Of the different proposals put forward, Alternative A seems to have been received most favourably by market participants. However, even with the Alternative A approach, there are concerns that different approaches could be used in different jurisdictions.

"The reaction of industry participants, outside of a minority, showed a preference for Alternative A. The modified SFA – which is at the top of that hierarchy – is one that many of the banks and institutions applying it will be familiar with, although the current SFA has been amended to include

a maturity adjustment and the supervisory add-ons of 'tau' and 'omega' have been adjusted. At least as a base case, it bears some resemblance to the IRB framework in terms of risk sensitivity," says Day.

He continues: "Risk sensitivity is important and, although Alternative B does have that sensitivity, it only has it in relation to senior high quality tranches. Outside of that, you would have to use a concentration ratio approach, which in many cases leads to higher capital charges."

The different treatment for senior high quality tranches under Alternative B is also troublesome. As it is such a subjective measurement, it is likely that banks will simply use ratings as a proxy in those situations – which is precisely what the proposed changes are supposed to avoid.

"People do not like the fact that Alternative B has two different streams, depending on whether the securitisation exposure is a senior high quality tranche or not. If you have a securitisation exposure which is no longer considered to be high quality, then you have to use a totally different approach – and while there is some flexibility on which approach can be used at the top of the Alternative B hierarchy for senior high quality tranches, those approaches are not available for other exposures," adds Craske.

Alternative B also throws up the possibility of a senior high quality tranche becoming subject to a different approach if it is downgraded. A tranche could go from the modified SFA to the KIRB concentration approach, which would lead to a significant change in outcome.

In many cases, the regulatory capital requirements under the new approaches are considerably more conservative. Craske points out that a senior triple A-rated tranche's risk weight could increase from 7% under the current IRB approach to 58%. The inclusion of a maturity adjustment in the modified SFA and the revised ratings-based approach also appears to bring in an element of double-counting.

The revised ratings-based approach will not be available in the US after Dodd-Frank required the removal of references to ratings in regulations. As well as this potential conflict, the way the proposed simplified SFA would be used as an alternative to the revised ratings-based approach is far more conservative in Europe than it is in the US.

"The element of jurisdictional choice in the proposals means that the regulatory capital requirements could differ between countries. While many may prefer the simplicity of a ratings-based approach, there is also the question of how this will interrelate with CRA 3," says Craske.

Day adds: "While the simplified SFA is intended as an alternative to the revised ratings-based approach – and the capital requirements under those approaches are intended to be broadly aligned – the supervisory adjustment factor within the proposed simplified SFA is set at 1.5, so is calibrated more conservatively than in the US version of the simplified SFA, where it is 0.5."

Recognition that overly conservative capital requirements could make securitisation uneconomic appears to be broadening. The so-called arbitrage-free approach recently put forward by an industry working group (SCI 27 June), for example, proposes markedly different capital requirements from those suggested by the Basel Committee and would make securitisation far less punitive.

Day believes this counter-proposal will be kept in mind as changes to the Basel proposals are considered. He says: "The initiative shown by that working group is to be appreciated. You do get unintended consequences when you apply certain hierarchies and it is true that you may end up in this perverse outcome where you are holding far more capital purely by virtue of the exposure

having been securitised. I am sure the Basel Committee is carefully considering all reactions and comments."

The next step is for the Basel Committee to digest the feedback it has received and then, hopefully, put fresh proposals out for consultation. How long that process will take is unclear, however, with a quantitative impact study due to be resolved first.

"There is a lot going on," says Day. "We have now got CRD IV and CRA 3, while a new Basel discussion paper has just been launched and the US has just adopted the Basel 3 standards. We would hope to see something further on the Basel securitisation framework before the end of the year, with a further comment period in time for the revised framework being finalised for implementation during 2014."

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This article was published in [Structured Credit Investor](#) on 23 July 2013.