

Clients & Friends Memo

Amendments to the Basel Securitisation Framework – Alternative Capital Treatment for Simple, Transparent and Comparable Securitisations

3 August 2016

Introduction

The Basel Committee on Banking Supervision (the “**Basel Committee**”) published an updated version of the “Basel III Document – Revisions to the securitisation framework” on 11 July 2016¹ (the “**Amended Securitisation Framework**”). This now includes alternative regulatory capital treatment for securitisation transactions which meet the criteria for identifying simple, transparent and comparable securitisations. In this Clients & Friends Memo we discuss the background to this document and consider the amendments which have been made and how they will affect securitisation transactions.

The Securitisation Framework

The final version of the revised securitisation framework was published by the Basel Committee on 11 December 2014 (the “**Revised Securitisation Framework**”),² following two previous proposals³ and a consultation process. The Revised Securitisation Framework is part of an ongoing series of reforms, following the financial crisis, to the international banking regulatory accord known as Basel II. It sets out revised methodologies for the calculation of regulatory capital requirements for securitisation exposures⁴ held by banks in their banking book, in order to address certain shortcomings identified by the Basel Committee under the previous

¹ *Basel III Document – Revisions to the securitisation framework – Amended to include the alternative capital treatment for “simple, transparent and comparable” securitisations*, 11 December 2014 (rev. July 2016), <http://www.bis.org/bcbs/publ/d374.pdf>.

² *Basel III Document – Revisions to the securitisation framework*, 11 December 2014, <http://www.bis.org/bcbs/publ/d303.pdf>.

³ *Consultative Document – Revisions to the Basel Securitisation Framework*, published in December 2012, <http://www.bis.org/publ/bcbs236.pdf> and *Consultative Document – Revisions to the securitisation framework*, published in December 2013, <http://www.bis.org/publ/bcbs269.pdf>.

⁴ Securitisation exposures may include investments in asset-backed securities, retention of subordinated tranches, credit enhancement, liquidity facilities, interest rate and currency swaps and credit derivatives.

securitisation framework.⁵ It is scheduled to come into effect in January 2018. The Revised Securitisation Framework includes a revised hierarchy of approaches to be used to determine the relevant amount of regulatory capital, depending on the approach to credit risk used by banks for the type of underlying exposures which have been securitised. This hierarchy of approaches starts with the Securitisation Internal Ratings-Based Approach (“**SEC-IRBA**”), which is followed by the Securitisation External Ratings-Based Approach (“**SEC-ERBA**”)⁶ and then the Securitisation Standardised Approach (“**SEC-SA**”).⁷

For further discussion and analysis of the Revised Securitisation Framework please see our Clients & Friends Memo entitled “[Revisions to the Securitisation Framework: Final Rules published by the Basel Committee](#)” dated 15 May 2015.

Criteria for identifying Simple, Transparent and Comparable Securitisations

The criteria for identifying so-called simple, transparent and comparable (“**STC**”) securitisations were published by the Basel Committee and the Board of the International Organization of Securities Commissions in July 2015,⁸ following the publication of a consultative document in relation to capital treatment for STC securitisations in November 2015 (the “**STC Consultative Document**”)⁹ and the submission of comments by various interested parties.

The intention behind the creation of the STC criteria is to identify and assist in the development of simple and transparent securitisation structures. The STC criteria are not intended to be a substitute for due diligence by investors. By “simple”, the Basel Committee means structures that are not overly complex and where the underlying assets are homogeneous and have simple characteristics. “Transparent” refers to transactions where investors have sufficient information on the underlying assets, the structure and the parties, and therefore should have a detailed understanding of the risks involved in the transaction. The requirement for transactions to be “comparable” is intended to enable more straightforward comparisons across securitisations with a particular asset class, taking into account differences between jurisdictions.

In a parallel process, the European Commission has been developing its own set of proposals to set out a similar set of criteria, under the draft EU Regulation laying down common rules on securitisation and creating a European framework for simple, transparent and standardised

⁵ These were (a) mechanistic reliance on external ratings, (b) excessively low risk weights for highly rated securitisation exposures, (c) excessively high risk weights for low-rated securitisation exposures, (d) so-called “cliff effects” and (e) insufficient risk sensitivity.

⁶ This approach will not be available in the United States since references to credit ratings in regulations are not permitted under the Dodd-Frank Wall Street Reform and Consumer Protection Act.

⁷ If none of these approaches can be used, a 1,250% risk weight will apply.

⁸ *Criteria for identifying simple, transparent and comparable securitisations*, www.bis.org/bcbs/publ/d332.pdf.

⁹ *Consultative Document – Capital treatment for “simple, transparent and comparable” securitisations*, www.bis.org/bcbs/publ/d343.pdf.

(“**STS**”) securitisation (the “**Draft EU Securitisation Regulation**”).¹⁰ For further analysis of these proposals, please see our Clients & Friends Memos entitled “[Securitisation: Keeping it Simple?](#)” dated 1 October 2015 and “[European Parliament Rapporteur Publishes Draft Amendments to the Proposed EU Securitisation Regulation](#)” dated 10 June 2016. The development of STC and STS criteria can be seen as recognition of the arguments by participants in the securitisation industry that many securitisations performed very well during the financial crisis and that securitisation is an important funding source which should not be unduly penalised.

The STC criteria cover three key types of risk in a securitisation:

- Asset risk, being the risk of the underlying assets in the transaction (criteria A1 – A6);
- Structural risk, concerning transparency around the securitisation structure (criteria B7 – B12); and
- Fiduciary and servicer risk, relating to the governance of key transaction parties (criteria C13 – C14).

In addition, certain additional criteria have been included for capital purposes (criteria D15 – D16) and certain of the other criteria contain additional guidance with reference to their application for regulatory capital purposes.

Summary of the STC Criteria

Below is a summary of some key aspects of the STC criteria.

Asset risk

A1. Nature of assets

The underlying assets should be homogeneous. This should be assessed by looking at the type of assets, jurisdiction, legal system and currency. Interest payments or discount rates should be based on commonly encountered market interest rates¹¹ and should not reference complex formulae or exotic derivatives.

Where this criterion is being used for capital purposes, the assets should not require analysis of materially different legal and/or credit risk factors, there should be common risk drivers, there should be standard obligations in terms of rights to payments and/or income, with a periodic

¹⁰ See the *Proposal for a Regulation of the European Parliament and of the Council laying down common rules on securitisation and creating a European framework for simple, transparent and standardised securitisation and amending Directives 2009/65/EC, 2009/138/EC, 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012 – Presidency compromise*, 30 November 2015, <http://data.consilium.europa.eu/doc/document/ST-14537-2015-INIT/en/pdf> and also the *Draft Report* by Rapporteur Paul Tang, 6 June 2016, <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2f%2fEP%2f%2fNONSGML%2bCOMPARL%2bPE-583.961%2b01%2bDOC%2bPDF%2bV0%2f%2fEN>.

¹¹ This includes interbank rates such as LIBOR, EURIBOR and the federal funds rate and sectoral rates which reflect a lender's cost of funds.

and well-defined stream of payments, and investors should be repaid primarily from the proceeds of the assets.¹²

A2. Asset performance history

Performance data for similar assets should be available for a sufficiently long period to allow investors to carry out their evaluation of expected loss.

For capital purposes, it is necessary that the originator has sufficient experience of originating similar exposures and an appropriately long performance history, being no shorter than seven years for non-retail exposures or five years for retail exposures – the latter criterion is intended to avoid originate-to-distribute type behaviour.

A3. Payment status

The underlying pool of assets may not include obligations that are in default, delinquent or in relation to which there is evidence of a material increase in expected losses or enforcement. For capital purposes, there are more detailed conditions to avoid the inclusion of assets where the obligors are credit-impaired.

A4. Consistency of underwriting

The originator needs to be able to demonstrate to investors that the credit claims or receivables have been originated in the ordinary course of its business to materially non-deteriorating underwriting standards.

For capital purposes, the assets are required to have been originated in accordance with sound and prudent underwriting criteria, requiring an assessment that the obligor has the ability and volition to make timely payments.

A5. Asset selection and transfer

The underlying assets must be subject to clearly defined eligibility criteria. It is not permitted for there to be any active management of the pool on a discretionary basis.¹³ It is a requirement that there is a true sale of the receivables, which includes an assessment that there are no material recharacterisation or clawback risks, and for capital purposes, the true sale analysis is required to be confirmed by a legal opinion. Resecuritisations are excluded.

A6. Initial and ongoing data

Loan-level data or, in the case of granular pools, summary stratification data on the relevant risk characteristics of the underlying pool, should be available to potential investors both prior to pricing and at least quarterly, and the initial portfolio should be subject to a third party review.

¹² There may be some reliance on refinancing or resale of assets provided that this is not substantial – refinancing needs to be sufficiently distributed within the pool and the residual values need to be sufficiently low.

¹³ It is acceptable to provide for the addition of assets during a revolving period or the substitution and repurchase of assets due to breach of representations and warranties on the condition that there is no cherry-picking of assets.

Structural risk*B7. Redemption cash flows*

There should be no reliance on the sale or refinancing of underlying credit claims or receivables to repay the liabilities unless the pool is sufficiently granular.

B8. Currency and interest rate asset and liability mismatches

Interest rate and foreign currency risks should be appropriately mitigated at all times and any hedging agreements should be documented according to industry-standard master agreements. For capital purposes, further information on the amount hedged and a risk sensitivity analysis need to be provided on a regular basis.

B9. Payment priorities and observability

Priorities of payments for all liabilities in all circumstances need to be clearly defined and legal comfort regarding their enforceability should be obtained. Junior liabilities should not be payable in priority to senior liabilities which are due and payable, and sequential amortisation in order of seniority is required on termination. All triggers affecting the cash flows and priority of payments need to be fully disclosed. Securitisations with a revolving period need to include early amortisation events and/or triggers for termination of the revolving period.¹⁴ Cash flow models or information which would allow cash flows to be modelled need to be provided.

B10. Voting and enforcement rights

Voting and enforcement rights must be clearly defined.

B11. Documentation disclosure and legal review

Initial offering documents and draft underlying transaction documents need to be provided prior to pricing, and final documentation needs to be provided on or shortly following the closing. Third party legal review of documentation is required.

B12. Alignment of interests

The originator or sponsor is required to retain a material net economic exposure and demonstrate a financial incentive in the performance of the securitised assets.

Fiduciary and servicer risk*C13. Fiduciary and contractual responsibilities*

Servicers need to have expertise and extensive servicing experience and should act in accordance with reasonable and prudent standards. Servicers should also have strong systems and reporting capability, and for capital purposes, a third party review of these aspects may be required in the case of a servicer which is not a banking entity.

¹⁴ Such events and/or triggers should include (a) deterioration in credit quality of the underlying exposures, (b) failure to acquire sufficient new underlying exposures of similar credit quality and (c) an insolvency-related event of the originator or servicer.

Trustees need to act on a timely basis in the best interests of the noteholders and need to have sufficient skills and resources. Provisions must be included setting out how conflicts between different classes of noteholders should be resolved on a timely basis.

C14. Transparency to investors

The contractual obligations of all key parties to the transaction must be clearly defined. Provisions for the replacement of certain important parties – servicers, account banks, hedge counterparties and liquidity providers – should be included. All income and disbursements of the securitisation need to be included in performance reports to investors.

Additional criteria for capital purposes

D15. Credit risk of underlying exposures

As at the portfolio cut-off date, the underlying assets must not exceed certain maximum risk weights.¹⁵

D16. Granularity of the pool

As at the portfolio cut-off date, the aggregate of all exposures to a single obligor in the pool should not exceed 1% of the total of all exposures in the pool.¹⁶

Effect of the incorporation of the STC Criteria

In the Amended Securitisation Framework, the Basel Committee has recognised the lack of capital neutrality in the securitisation framework, i.e. the fact that the total amount of regulatory capital required for all tranches of a securitisation is greater than the amount of capital for the underlying pool – a point which market participants have been making for some time. It is accepted that a securitisation with lower structural risk should require lower amounts of regulatory capital than a securitisation with higher structural risk, and a securitisation with fewer risky underlying assets should require lower amounts of regulatory capital than a securitisation with riskier underlying assets.

Consequently, the three approaches in the hierarchy have been modified to result in lower regulatory capital requirements for STC securitisations.

¹⁵ These are, under the Standardised Approach and after taking into account any eligible credit risk mitigation:

- [40]% on a value-weighted average exposure basis for the portfolio in the case of loans secured by residential mortgages or fully guaranteed residential loans;
- [50]% on an individual exposure basis in the case of loans secured by commercial mortgages;
- [75]% on an individual exposure basis in the case of retail exposures; or
- [100]% on an individual exposure basis in the case of any other exposures.

The exact percentages are still to be finalised.

¹⁶ The criterion requiring the servicer and the originator to be the same legal entity or affiliates which was proposed in the STC Consultative Document has now been dropped.

At the top of the hierarchy, the SEC-IRBA formula has been amended to include a factor of 0.5 in the supervisory parameter p .¹⁷

The SEC-ERBA risk weight look-up tables for long-term and short-term ratings have been adjusted to provide lower risk weights for STC securitisations. For example, AAA-rated senior tranches of STC securitisations will have a risk weight of 10%, compared with a risk weight of between 15% and 20% for non-STC securitisations, depending on maturity.

The supervisory parameter p in the SEC SA approach formula has been set at 0.5 for STC securitisations (as opposed to 1 for non-STC securitisations).¹⁸

In all three approaches, a risk weight floor of 10% will apply to senior tranches and 15% for non-senior tranches, compared with a risk weight floor of 15% for non-STC securitisations.

While the STC Consultative Document proposed that both the originator/sponsor and the investor would be required to determine compliance with the STC criteria for regulatory capital purposes, the Amended Securitisation Framework requires only the investor to assess compliance.¹⁹ Originators will be obliged to disclose all necessary information to investors to allow them to determine whether the STC criteria are met and will be liable for misrepresentations or inaccurate information.

The STC criteria will need to be met at all times in order to benefit from the preferential regulatory capital treatment. Investors will be expected to take into account any developments that may affect the STC determination, and where the pool is dynamic, compliance with the criteria will be required to be assessed each time that assets are added to the pool.

Supervisors will be required to review a bank's determination that its securitisation exposures meet the STC criteria and, if they are not satisfied with that determination, the relevant supervisor would be able to take remedial action or deny preferential regulatory capital treatment for that transaction, and potentially, for future transactions.

The Amended Securitisation Framework also provides that if a jurisdiction considers that the costs of incorporating the STC criteria into the capital framework exceed the potential benefits, it retains the option not to incorporate them.

Conclusions

Given the significant increases in risk weights for securitisation exposures which were brought in under the Revised Securitisation Framework, banks are likely to welcome reductions in risk weights for STC securitisations. However, there are a number of issues to be considered.

¹⁷ This is lower than the range of 0.6 to 0.8 considered in the STC Consultative Document.

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¹⁹ This is in contrast to the Draft EU Securitisation Regulation where the originator, sponsor and issuer are required jointly to notify ESMA (the European Securities and Markets Authority) that a securitisation meets the STS criteria.

Firstly, the STC criteria themselves are likely to be too restrictive to allow their application to various securitisation transactions. CMBS and managed CLO transactions will not fall within the STC criteria, and synthetic transactions remain ineligible. Securitisations which use ABCP conduits or programmes currently remain excluded (unlike the proposed STS criteria, which contain a specific set of criteria for ABCP securitisations), although the application of STC criteria to transactions funded via ABCP remains under consideration and a consultation process is expected to start around the end of 2016.

The requirement for homogeneity to be assessed with respect to jurisdiction, legal system and currency will be problematic for multi-jurisdictional transactions. The additional criterion D15 is of particular concern since it may not be possible to meet the maximum risk weight requirements for the underlying assets. Criterion D16 is also likely to restrict the availability of the STC regulatory capital treatment since it is not unusual for securitisations such as trade receivables deals to have receivables relating to a particular obligor which exceed 1% of the pool. It would be disappointing if some securitisation transactions are precluded from benefiting from lower risk weights even where similar transactions have generally performed well in the past and where the risks of the transaction are taken into account in the structuring, for example, through the application of reserves and concentration limits.

Furthermore, there are likely to be some difficulties in interpreting the wording of the criteria and banks will remain concerned by the extent to which the total capital requirements for a securitisation remain substantially higher than the capital requirements for the underlying assets, and significantly higher than for other methods of funding.

In the European context, the Capital Requirements Regulation is currently the subject of proposed amendments (the “**Draft Revised Capital Requirements Regulation**”),²⁰ which are being considered at the same time as the Draft EU Securitisation Regulation, and which include preferential treatment for STS securitisations. While there is substantial overlap conceptually between the STC and the STS criteria, they are different in a number of respects and the wording differs between the two. The possibility that different criteria will apply for different jurisdictions (or such criteria may not be available at all in a jurisdiction), and the potential prospect of having to comply with two sets of criteria for the same transaction, will give rise to concerns. In addition, it is worth mentioning that, while the hierarchy of approaches in the Draft Revised Capital Requirements Regulation generally reflects the Revised Securitisation Framework, the SEC-ERBA risk weights for STS securitisations under the Draft Revised Capital Requirements Regulation are not currently aligned with those in the Amended Securitisation Framework and it is proposed in the Draft Revised Capital Requirements Regulation that if the SEC-ERBA would result in incommensurate regulatory capital requirements relative to the credit risk of the underlying exposures in relation to a senior STS securitisation position, then institutions may be able to apply the SEC-SA instead. There is also a suggestion that the SEC-ERBA should be eliminated altogether for STS securitisations, since it may lead to substantially higher capital requirements than the other approaches and could

²⁰ See the *Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms – Presidency compromise*, 30 November 2016, <http://data.consilium.europa.eu/doc/document/ST-14536-2015-INIT/en/pdf>.

result in higher capital charges in countries where ratings caps apply.²¹ In the case of the United Kingdom, it is not yet known whether the Basel or the EU approach, or indeed a different approach altogether, will apply with respect to capital requirements for both STC and non-STC securitisations, following the result of the “Brexit” referendum and the attendant ongoing discussions regarding its relationship with the European Union. These potential variances in approach between different jurisdictions raise questions about the effect of the lack of a level playing field and the possibilities for regulatory arbitrage.

It would be unfortunate if, despite the work that has gone into the development of the STC and STS criteria and the recognition that many securitisations are of good quality and likely to perform well, the relevant criteria remain too restrictive and the regulatory benefits are insufficient. Market participants will be hoping that the incorporation of the Amended Securitisation Framework in the relevant jurisdictions will be carried out in such a way as to allow the development of a securitisation market which is subject to prudent but not unduly onerous regulation, in order to facilitate the availability of securitisation as an important funding source to the real economy.

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Please feel free to contact the authors of this Clients & Friends Memo, Merryn Craske and Stephen Day or any of the other Cadwalader lawyers listed below if you would like to discuss any of the issues discussed in this Clients & Friends Memo.

Merryn Craske	+44 (0) 20 7170 8662	merryn.craske@cwt.com
Stephen Day	+44 (0) 20 7170 8535	stephen.day@cwt.com
Bruce Bloomingdale	+44 (0) 20 7170 8540	bruce.bloomingdale@cwt.com
Angus Duncan	+44 (0) 20 7170 8640	angus.duncan@cwt.com
David Quirolo	+44 (0) 20 7170 8635	david.quirolo@cwt.com
Nick Shiren	+44 (0) 20 7170 8778	nick.shiren@cwt.com
Jeremiah Wagner	+44 (0) 20 7170 8542	jeremiah.wagner@cwt.com
Robert Cannon	+44 (0) 20 7170 8735	robert.cannon@cwt.com

²¹ See the *Draft Report* by Rapporteur Pablo Zalba Bidegain, 6 June 2016, <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2f%2fEP%2f%2fNONSGML%2bCOMPARL%2bPE-583.904%2b01%2bDOC%2bPDF%2bV0%2f%2fEN>. This also includes a proposal to allow the use of proxy data in the calculation under the SEC-IRBA which would bring this in line with the US, and this is likely to be welcomed by the securitisation industry.