

Clients & Friends Memo

What's Next for the Basel Securitisation Framework?

9 May 2013

Comments have now been received by the Basel Committee on Banking Supervision (the “**Basel Committee**”) in response to its consultative paper entitled “Revisions to the Basel Securitisation Framework”, published in December 2012 (the “**Consultation Paper**”). The Consultation Paper contains important proposals for revisions to the regulatory capital requirements in relation to securitisation exposures.¹ Many of the respondents expressed concern about various aspects of the proposals and the potential consequences for the securitisation industry.

In this Clients & Friends Memo, we consider the key proposals set out in the Consultation Paper² and summarise some of the comments received.³

Background

Under the securitisation framework established under Basel II,⁴ banks are required to hold regulatory capital against all their securitisation exposures (including those arising from the provision of credit risk mitigants, investments in asset-backed securities, retention of subordinated tranches, and the extension of liquidity facilities and credit enhancement).

The Basel Committee has carried out a review of the securitisation framework with reference to certain issues which arose during the financial crisis. The Basel Committee's view is that evidence from the financial crisis has indicated that capital requirements for highly-rated securitisation exposures are too low, particularly in the case of resecuritisations, and has brought into question the previously assumed benefits of diversification by means of securitisation. In particular, the Basel Committee has identified that the current securitisation framework does not appropriately address the risk associated with longer maturity dates or take

¹ The full text of the Consultation Paper can be found at <http://www.bis.org/publ/bcbs236.pdf>.

² Please note that this Clients & Friends Memo does not cover all aspects of the proposals, which are described in detail in the Consultation Paper.

³ The comments received by the Basel Committee and published on the Bank for International Settlements website can be found at <http://www.bis.org/publ/bcbs236/comments.htm>.

⁴ References to “Basel II” in this Clients & Friends Memo are to the framework set out in the document entitled “International Convergence of Capital Measurement and Capital Standards – A Revised Framework, Comprehensive Version” published in June 2006, which can be found at <http://www.bis.org/publ/bcbs128.pdf>, as amended.

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account of the thickness of tranches. It also considers that the risk weights for low-rated senior securitisation exposures are too high. The proposals in the Consultation Paper are intended to make capital requirements more prudent and risk sensitive, mitigate mechanistic reliance on external credit ratings, and reduce cliff effects.⁵

The proposed revisions to the securitisation framework include:

- two possible new hierarchies of approaches to determining the regulatory capital requirements for securitisation exposures;
- enhancements to the current ratings-based approaches and supervisory formula approach in the Basel II securitisation framework;
- the introduction of a simplified supervisory formula approach and different applications of the concentration ratio based approach included in the enhancements to the trading book under Basel 2.5,⁶ including a backstop concentration ratio approach, and the requirement to use a concentration ratio based approach for resecuritisation exposures; and
- other changes, including an extension of the 20% risk-weight floor under the standardised approach ("SA") for calculating capital requirements for securitisation exposures, to banks that use an internal ratings based ("IRB") approach.

The Basel Committee had invited feedback on the proposed changes by 15 March 2013, in particular, on the calibration of the relevant capital charges, the underlying assumptions and the requirements for applying each method of calculating the capital charges, and included a series of specific questions for consideration. Banks were also encouraged to participate in a quantitative impact study ("QIS"). Comments on the proposals from more than 40 industry participants were published on the Bank for International Settlements website in April 2013.

The Current Securitisation Framework

Under the current securitisation framework, there are two approaches – the SA and the IRB approach, each with different hierarchies.

Banks which apply the SA for the type of underlying exposures that are securitised must apply a ratings based approach to rated securitisation exposures using the risk weights set out in the relevant table. In the case of unrated securitisation exposures, these would, under Basel II, be

⁵ Cliff effects were observed during the financial crisis where small changes in the quality of the underlying pool of securitised exposures quickly led to significant increases in capital requirements.

⁶ References to "Basel 2.5" in this Clients & Friends Memo are to certain amendments made to Basel II which were made to address deficiencies identified during the financial crisis, as set out in the documents entitled "Enhancements to the Basel II framework", which can be found at <http://www.bis.org/publ/bcbs157.pdf>, "Revisions to the Basel II market risk framework", which can be found at <http://www.bis.org/publ/bcbs193.pdf>, and "Guidelines for computing capital for incremental risk in the trading book", which can be found at <http://www.bis.org/publ/bcbs159.pdf>.

required to be deducted from regulatory capital, while under Basel III,⁷ such exposures will instead be subject to a 1250% risk weight. However, banks may use alternative treatments for the most senior exposure in a securitisation, certain asset-backed commercial paper (“**ABCP**”) exposures that are in a second-loss position or better and eligible liquidity facilities.

Banks which apply the IRB approach to the type of underlying exposures that are securitised must apply a ratings based approach to securitisation exposures that are rated or where a rating can be inferred, using the risk weights set out in the relevant tables (which differ from the SA tables, and in most cases have lower risk weights). Where an external or inferred rating is not available, the relevant bank must use one of the following methods. For certain ABCP programme exposures, such as liquidity facilities and credit enhancement, the bank may use an internal assessment approach (“**IAA**”), subject to certain operational requirements. Under the IAA, the bank’s internal assessments of the credit quality of its ABCP programme exposures would be mapped to external ratings and used to determine the appropriate risk weights under the ratings based approach. Otherwise, the bank must use a supervisory formula approach (“**SFA**”), which requires five bank-supplied inputs - the IRB capital charge had the underlying exposures not been securitised (referred to as K_{IRB} ⁸), the tranche’s credit enhancement level and thickness, and the pool’s effective number of exposures and exposure-weighted average loss given default. Again, if the bank were unable to use any of these approaches, the relevant exposures would, under Basel II, be required to be deducted, and will instead be subject to a 1250% risk weight under Basel III.

New Hierarchies – Alternative A and Alternative B

The Consultation Paper proposes two possible replacement hierarchies, Alternative A and Alternative B, each with a revised set of approaches, together with some new approaches. Under these hierarchies, the SA and the IRB approach would be more closely aligned. However, these new hierarchies would not apply to resecuritisations, which would be subject to a concentration ratio approach.

Alternative A

At the top of the hierarchy for Alternative A, there would be a modified version of the SFA in Basel II, referred to as the Modified Supervisory Formula Approach (“**MSFA**”). A bank would be required to apply the MSFA provided that:

- (i) the bank’s supervisor had not restricted the use of the MSFA for the relevant structure or transaction;

⁷ References to “Basel III” in this Clients & Friends Memo are to the documents entitled “Basel III: a global regulatory framework for more resilient banks and banking systems”, published in December 2010 and revised in June 2011, which can be found at <http://www.bis.org/publ/bcbs189.pdf>, “Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools”, published in January 2013, which can be found at <http://www.bis.org/publ/bcbs238.pdf>, and other associated reforms by the Basel Committee.

⁸ K_{IRB} is the ratio of (a) the IRB capital requirement including the EL (expected losses) portion of the underlying exposures in the pool to (b) the exposure amount of the pool (eg. the sum of drawn amounts related to securitised exposures plus the EAD (exposure at default) associated with undrawn commitments related to securitised exposures).

- (ii) the bank had an IRB approach that had been approved by its supervisor for the type of underlying exposures in the securitised pool; and
- (iii) the bank had sufficient information to estimate IRB capital requirements for all the underlying assets in the securitised pool in compliance with IRB standards.

If the bank were unable to use the MSFA for a securitisation exposure, it would use either the revised Ratings Based Approach (“**Revised RBA**”) or the Simplified Supervisory Formula Approach (“**SSFA**”), depending on which approach were required by the supervisor in the relevant jurisdiction. Only one of these two approaches would be permitted to be used within a jurisdiction.

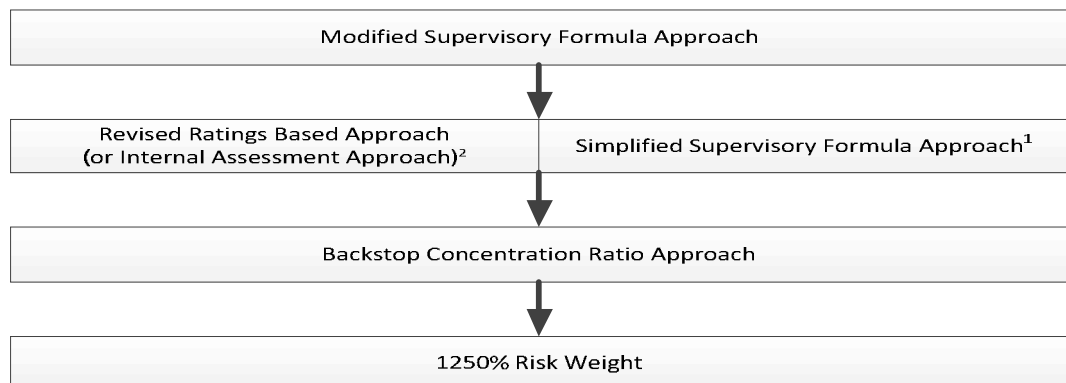
However, in the event that the Revised RBA had been chosen to apply in a particular jurisdiction, and provided that the bank were unable to use the MSFA, an IRB approach bank would still be permitted to use the IAA to calculate the capital requirements for unrated securitisation exposures to an ABCP programme such as liquidity facilities and credit enhancement, provided that the ABCP, the bank and the rating agency met the relevant requirements.

If the bank were unable to use the Revised RBA (or IAA) or the SSFA to calculate the capital requirements for a securitisation exposure, it would be required to use a backstop concentration ratio approach (“**BCRA**”), based on the concentration ratio included in the Basel 2.5 enhancements for trading book securitisation exposures.

If none of the above approaches could be used, the bank would be required to assign a 1250% risk weight to the securitisation exposure.

Below is a diagram of the proposed hierarchy for Alternative A:

Alternative A



¹ Supervisor would decide whether the Revised Ratings Based Approach or the Simplified Supervisory Formula Approach should be used in the relevant jurisdiction.

² IRB banks would be permitted to use the Internal Assessment Approach to calculate risk-based capital requirements for unrated securitisation exposures to an ABCP programme, provided certain conditions were met.

Alternative B

Under Alternative B, a bank would be required to distinguish senior high quality securitisation exposures from other securitisation exposures. A securitisation exposure would be regarded as “senior” if it were backed or secured by a first claim on the entire amount of the assets in the underlying securitised pool. Such a senior exposure could be determined to be “high quality” based on external information, such as ratings, market data and analysts’ reports, and the bank’s own assessment of credit risk.⁹

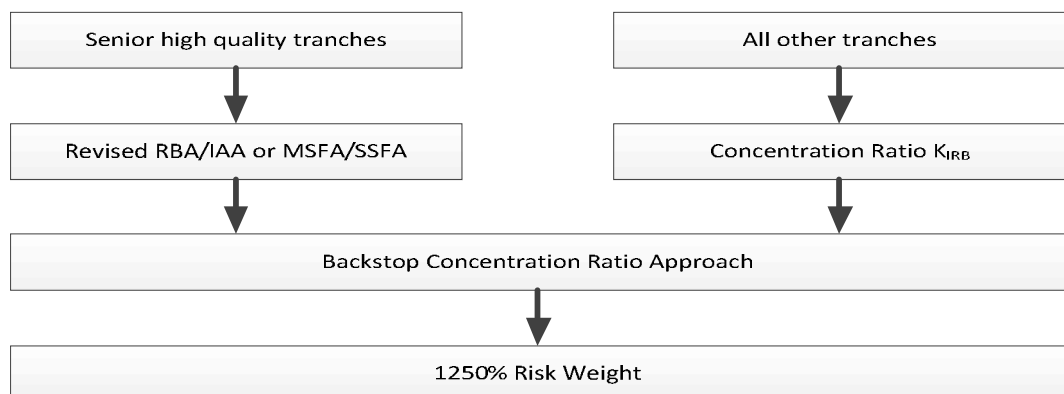
For such senior high quality exposures, the bank could choose to apply either the Revised RBA or the MSFA, as well as the IAA for ABCP exposures. In addition, if the bank were unable to use the MSFA, the SSFA could be used if permitted by its supervisor.

For securitisation exposures which are not senior high quality exposures, the bank would be required to use a concentration ratio approach based on the IRB capital requirements for the underlying pool of securitised assets (K_{IRB}).

As with Alternative A, if the bank were unable to use any of the applicable approaches, it would use the BCRA, and if the bank were unable to use the BCRA, it would be required to apply a 1250% risk weight to the exposure.

Below is a diagram of the proposed hierarchy for Alternative B:

Alternative B



⁹ The bank would need to demonstrate strong credit quality, very low default risk and invulnerability to foreseeable events, implying that financial commitments would be met in a timely manner with a very high probability. “High quality” would correspond to a long term credit rating of “AAA” to “AA-” or a short term credit rating of at least “A-1/P-1/F-1”.

Pros and Cons of Alternative A and Alternative B

The Consultation Paper sets out various pros and cons of the proposed hierarchies set out in Alternative A and Alternative B.

As regards Alternative A, the placing of the MSFA at the top of the hierarchy is expected to encourage the use of internal assessments of risk by a bank, instead of mechanistically relying on external ratings. However, the element of jurisdictional choice between the Revised RBA and the SSFA could result in different regulatory capital requirements across jurisdictions. The Basel Committee also expressed concern about the stability and reliability of supervisory formula approaches and the Revised RBA to set capital charges for securitisation exposures.

As regards Alternative B, the restriction of the Revised RBA and the supervisory formula approaches to high quality senior tranches is expected to mitigate model risk. In the case of exposures which are not senior high quality tranches, all jurisdictions would implement the same approach and external ratings would not be relevant in determining capital requirements for those exposures. However, the Consultation Paper makes the point that the determination of whether a tranche is “high quality” could be subjective and could continue to involve the use of external credit ratings. It is also possible that if an exposure no longer qualified as “high quality”, this could still result in cliff effects due to the change in the applicable approach.

Details of the Proposed Approaches**MSFA**

The Basel Committee’s view is that the existing SFA does not fully reflect the possibility of mark-to-market losses to tranche exposures resulting from future credit deterioration in the underlying asset pool. In order to address this, it proposed amending the SFA to incorporate an adjustment for the maturity of the tranche (as discussed further below).

In order to use the MSFA, a bank would need an IRB model for the type of underlying exposures in the securitisation pool that had been approved by its supervisor and sufficient information to estimate IRB capital requirements for all of the underlying exposures. This represents a change from the current framework which requires that where a bank is using the IRB approach for some exposures and the SA for other exposures in the securitisation pool, it should generally use the approach corresponding to the predominant share of exposures within the pool.

The required inputs for the MSFA would be (i) loan-by-loan IRB estimates of the underlying assets, (ii) maturity of the tranche, (iii) attachment point of the tranche, representing the percentage threshold at which credit losses would first be allocated to the securitisation exposure, and (iv) detachment point of the tranche, representing the percentage threshold at which credit losses of principal allocated to the securitisation exposure would result in a total loss of principal.

In addition, certain supervisory add-ons (“tau” and “omega”) would be adjusted in the MSFA calculation. These changes, together with the maturity adjustment, would be expected to lead to significantly higher capital requirements for certain securitisation exposures than under the SFA.

Revised RBA

The Consultation Paper proposes that the Revised RBA replace the separate SA and IRB approach look-up tables for long-term ratings. At least two eligible credit ratings (external or inferred) would be required to use the Revised RBA for a particular securitisation exposure and the bank would be required to use the second best credit rating.

The Basel Committee considers the seniority of the tranche, the thickness of non-senior tranches and the maturity of the tranche (as discussed further below) to be important risk drivers in formulating the Revised RBA. However, there would no longer be any distinction between granular and non-granular pools (the latter currently attract higher capital charges under the IRB approach).

The illustrative Revised RBA risk weights in the Consultation Paper indicate significant increases from the current tables. For example, the lowest risk weight for a senior exposure with a long-term rating of AAA and with a maturity of 5 years or more, currently 7% under the IRB approach, would increase to 58%. Other investment grade exposures would also be subject to increased risk weights.

For exposures with short-term ratings, such as ABCP, it is proposed the current risk weights under the RBA for the SA would apply not only to banks using the SA, but also to banks using IRB approach. This means, for example, for banks that use the IRB approach, that the risk weight for a securitisation exposure with a short-term rating of “A-1/P-1” would increase from 7% to 20%.

SSFA

The SSFA has been proposed in recognition that the use of or reference to credit ratings in regulations is prohibited in certain jurisdictions and that the availability of ratings for securitisation exposures is limited in some jurisdictions. The starting point for the formula is the weighted average capital requirement of the underlying exposures, calculated using the SA methodology. Risk weights would then be assigned based on the subordination level of the relevant tranche, taking account of the attachment and detachment points of the relevant tranches and the amount of “delinquent exposures”, meaning that higher capital requirements would be assigned to more risky junior tranches. There is also a supervisory adjustment factor, referred to as “*p*”, set at 1.5. Capital requirements under the SSFA are expected to be slightly higher than under the MSFA. The Basel Committee intends to use the results of the QIS to try to ensure that capital requirements under the SSFA are broadly aligned with those under the Revised RBA.

Concentration Ratio based on K_{IRB}

Under Alternative B, capital requirements for securitisation exposures which are not senior high quality tranches would be calculated under a concentration ratio based on K_{IRB} , provided that the IRB parameters could be estimated for all the underlying exposures.

BCRA

The BCRA is a fallback approach under each of Alternative A and Alternative B. The bank would use as inputs the capital charges applicable to the underlying pool using risk weights under the SA, and would include a multiplier (" F ") which would be set at 1 for senior securitisation exposures and 2 for non-senior securitisation exposures.

The BCRA formula would be the only available approach for resecuritisations, applied using the capital charges of the underlying securitisation exposures calculated under the revised framework and with different values for F . F would be set at 1 if all the underlying exposures were securitisation exposures.

Other Proposed Revisions**Maturity**

Maturity of a tranche, which would be used in the calculations under the Revised RBA and the MSFA, would be based on the weighted average maturity of the contractual cash flows of the relevant tranche, provided that those payments were unconditional and were not dependent on actual performance of the securitised assets, or alternatively, final legal maturity. Tranche maturity would have a 5 year cap and a 1 year floor.

Risk Weight Floor

The lowest risk weight would be 20%, for both long term and short term exposures. This matches the current SA floor, but is an increase from the floor of 7% under the IRB approach.

Overall Caps and Risk Weight Caps

The Consultation Paper provides that the overall cap for banks using the IRB approach on the maximum capital charge for their securitisation exposures would remain, and would be extended to originators and sponsors under the SA, so that the maximum capital requirement for such entities would be limited to the capital requirement that would apply under the SA if the bank held all the underlying exposures directly. In addition, risk weight caps would apply for senior securitisation exposures meaning that the risk weight would be capped at the risk weight of the underlying exposures.

Other Changes

Other changes include the removal of special treatment for exposures in a second loss position or better in ABCP programmes under the SA,¹⁰ eligible liquidity facilities under the SA,¹¹ liquidity facilities under the IRB approach¹² and early amortisation provisions.¹³

Industry Response – Overview

While many respondents expressed support for the Basel Committee's objectives of making capital requirements more prudent and risk sensitive, mitigating mechanistic reliance on external credit ratings and reducing cliff effects, numerous concerns were expressed about the proposed revisions and their potential consequences. Although there were many different comments and suggestions, below is a summary of some of the views put forward by securitisation industry participants.

Time Period for Analysis of the Proposals

It was noted that the time given to respond to the proposals had been very short, particularly considering the extent of the proposals. In addition, it was pointed out that the period for submission of comments overlapped with the period, ending on 29 March 2013, during which banks could submit data in relation to the QIS, and that the detailed working papers in relation to the MSFA and Revised RBA were published only in January 2013.¹⁴

Effect of Higher Capital Requirements

Since the proposed approaches would result in significantly higher capital requirements in many cases, a substantial number of respondents expressed concern that this could discourage participation in securitisation transactions. Investors would be likely to require higher yields to compensate for the increased regulatory capital requirements, thereby potentially increasing the cost of funding via securitisation or even, in certain cases, making it uneconomic. Alternatively, investors might elect to invest in other potentially riskier assets instead, in order to benefit from lower capital requirements and to try to obtain higher returns. Not only could the increase in capital requirements have a detrimental effect on the recovery of the securitisation industry, but if securitisation as a funding source became more expensive and

¹⁰ Under the proposals the BCRA would apply instead to such exposures.

¹¹ Under the SA, a 50% credit conversion factor is applicable to eligible liquidity facilities under Basel II, as amended by Basel 2.5. In addition, under the SA, for eligible liquidity facilities where the requirements for external ratings are not met, the applicable risk weight is equal to the highest risk weight assigned to any of the underlying individual exposures covered by the facility. Both these treatments would no longer be available.

¹² IRB banks would no longer be able to use SA risk weights when calculating the capital requirements for liquidity facilities.

¹³ Under the proposals, originators would be precluded from applying the securitisation framework for assets sold into securitisations with early amortisation features (except for certain exceptions) and the securitised assets would be assessed as if they were on balance sheet.

¹⁴ "Working Paper No. 22 - Foundations of the Proposed Modified Supervisory Formula Approach", which can be found at http://www.bis.org/publ/bcbs_wp22.pdf, and "Working Paper No. 23 – The Proposed Revised Ratings-Based Approach", which can be found at http://www.bis.org/publ/bcbs_wp23.pdf.

harder to obtain, this would also affect many who obtain funding via securitisation structures, and as a result this could have a negative impact on the broader economy.

Despite the overall caps on capital charges and caps on risk weights for senior exposures, respondents were concerned by the large differences between the overall capital requirements for securitisation exposures and the underlying assets if they had not been securitised. Some respondents also felt that the increased risk weights could actually result in the securitisation framework being less risk sensitive.

Regulation and Other Changes Since the Financial Crisis

Various respondents pointed out that there have already been a number of other regulatory reforms and other developments in response to the financial crisis which should be taken into account in revising the securitisation framework, including:

- (i) significant regulatory developments in relation to securitisation and capital requirements, such as:
 - the requirement that credit institutions should not be exposed to the credit risk of a securitisation position unless the originator, sponsor or original lender has agreed to retain a material economic interest of at least 5% (often referred to as “skin-in-the-game”, which was introduced with the intention of aligning the interests of such parties with investors and to address concern over “originate-to-distribute” arrangements), together with due diligence requirements, under Article 122a of CRD II;¹⁵
 - transparency measures under the disclosure requirements set out in CRD III¹⁶ and in the loan level reporting requirements applicable to asset-backed securities in order to satisfy the eligible collateral requirements of the European Central Bank and the Bank of England;
 - increased regulation of rating agencies;¹⁷ and

¹⁵ Article 122a was added to the European Union Capital Requirements Directive by Directive 2009/111/EC of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management. Note that similar requirements to ensure a 5% retention of a net economic interest in securitisations will also apply to insurance and reinsurance undertakings under Article 135 of Solvency II (Directive 2009/138/EC of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)) and to alternative investment funds under Article 17 of the AIFM Directive (Directive 2011/61/EU of 8 June 2011 on Alternative Investment Fund Managers).

¹⁶ Directive 2010/76/EC of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies.

¹⁷ For example, Regulation (EC) No 1060/2009 of 16 September 2009 on credit rating agencies.

- the reforms under Basel III, with respect to the quality and quantity of regulatory capital, the requirements for various capital buffers and the introduction of a leverage ratio and liquidity ratios;
- (ii) changes to rating agency methodologies and improvements in credit underwriting standards; and
- (iii) initiatives put in place by the securitisation industry, such as the Prime Collateralised Securities scheme established in 2012 which provides a “quality label” for securitisations.¹⁸

Performance of Securitisations

It was a common theme that, apart from certain exceptions, such as US sub-prime mortgage securitisations, performance of securitisations in many asset classes, such as European RMBS, and auto loans and credit cards, has actually been good. For example, GFMA¹⁹ pointed out that only 0.07% of European RMBS outstanding before the start of the financial crisis in 2007 have defaulted.

Jurisdictional Choice

Many respondents disliked the element of jurisdictional choice in Alternative A, and to a lesser extent in Alternative B, and felt that this should be avoided where possible, to ensure a level playing field and minimise arbitrage opportunities.

Grandfathering and Transition Period

In many cases, requests were made for grandfathering of current transactions and for a transition period.

Securitisation Exposures in the Trading Book

Some respondents raised the issue of how securitisation exposures in the trading book would be treated. The Consultation Paper indicated that since a fundamental review of the trading book rules is ongoing, no specific revisions to the trading book rules would be proposed at this stage. Banks have requested further clarification.

Preference between Alternative A and Alternative B

Alternative A was preferred by the vast majority of respondents who expressed a view on this issue, although respondents requested various changes to the hierarchy. There was a general view that the availability of the MSFA should be widened, and respondents made a range of

¹⁸ Respondents also noted other industry-led initiatives which may be beneficial for investors, i.e., the Standard for Dutch RMBS introduced by the Dutch Securitisation Association in November 2012 in order to standardise certain aspects of a prospectus and the standards established by True Sale International in Germany for auto ABS.

¹⁹ The Global Financial Markets Association, which comprises AFME (the Association for Financial Markets in Europe), SIFMA (the Securities Industry and Financial Markets Association) and ASIFMA (the Asia Securities Industry and Financial Markets Association).

other suggestions as to how the approaches within the hierarchy should be adjusted (as discussed further below).

As regards Alternative B, disadvantages identified by respondents were that (i) the determination of whether an exposure is high quality could be subjective, (ii) only concentration ratio approaches were available for securitisation exposures which were not senior high-quality exposures, and such approaches would not recognise the benefit of credit enhancement, and (iii) cliff effects would occur if a senior high-quality exposure ceased to fall into this category.

Industry Comments on Specific Aspects of the Proposals

MSFA

Many respondents felt that the requirement for banks to have sufficient information to estimate IRB capital requirements for all of the underlying exposures would limit the availability of the MSFA, since it was likely that only originators would have access to the relevant information in relation to the underlying pool. In addition, banks may not have an approved IRB model for the type of underlying exposures in the securitisation pool. As a result of these drawbacks, many banks would in fact be required to use the Revised RBA or SSFA.

Respondents suggested that it would be preferable to allow the use of pool-level data or to be able to apply the IRB approach to the predominant share of the exposures in the pool (rather than needing such data for each underlying exposure).

Respondents felt that the MSFA had been calibrated too conservatively and that the maturity adjustment was not appropriate (as discussed further below). Various respondents pointed out that the MSFA and the Revised RBA were calibrated by applying assumptions based on underlying corporate bonds and it was felt that it was not appropriate to apply this to well performing assets such as RMBS and ABS (eg. autos, credit cards and trade receivables).

It was argued that the credit enhancement effect of excess spread should be taken into account in the MSFA and the SSFA (which would be more consistent with the Revised RBA, since this would be taken into account in determining ratings).

Revised RBA

Many respondents thought the requirement for at least two external credit ratings was unnecessary. Some felt this was not consistent with the objective of reducing mechanistic reliance on external credit ratings. It also would not work in jurisdictions where the use of external credit ratings in regulation is not permitted, or in jurisdictions where ratings could not be obtained. In addition, it would be costly to arrange for a second rating, and this could be particularly difficult in the case of existing transactions.

Some respondents also pointed out that the use of external credit ratings is problematic where rating agencies apply a sovereign ceiling override, meaning that a good quality securitisation from a jurisdiction with a less good sovereign rating cannot achieve a higher rating.²⁰

SSFA

Many respondents argued that the supervisory adjustment factor of p should be set at the level of 0.5 as in the United States, as opposed to the proposed value of 1.5, on the grounds that the higher value makes the calculation unnecessarily conservative and could put non-US banks at a competitive disadvantage. It was highlighted that the proposed SSFA did not take account of differences in credit quality of the underlying exposures, making it difficult to align the risk weights under the Revised RBA (where this factor could be accounted for in the rating process) and the MSFA (which would take this into account in calculating the capital charges for the underlying assets).

BCRA

It was argued that the $F=2$ parameter is too conservative and noted that it does not take account of the credit enhancement provided by junior tranches.

Maturity

Many respondents pointed out that to include the effect of maturity in the calculations would introduce an element of double-counting since, in the case of the Revised RBA, rating agencies would already have taken account of maturity in assigning a rating, and in the case of the MSFA, maturity would be a factor in calculating the capital requirements for the underlying pool.

Respondents also felt that if a maturity adjustment were required to be included, it would not be appropriate to base this on contractual maturity. Instead, it should be based on weighted average maturity, in order to take into account factors such as prepayments and to avoid exaggerating the actual maturity.

20% Floor

It was argued that the 20% risk weight floor is too high and that the resulting increases in capital requirements were not appropriate. Respondents said that it should be reduced.

Securitisations with Early Amortisation Features

In the case of securitisations with early amortisation features, it was argued that banks should be able to treat those as securitisation exposures and recognise the transfer of risk.

²⁰ We note that the continued reference to external ratings under the Revised RBA in both Alternative A (albeit below the MSFA in the hierarchy) and Alternative B (albeit only available for senior high quality exposures), and as a factor in establishing whether a securitisation exposure is a senior high quality exposure under Alternative B, contrasts with the approach mandated in the United States under Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act) which requires the removal of any reference to credit ratings in regulations.

Resecuritisations

It was felt that the BCRA should not be the only available approach for calculating regulatory capital for resecuritisations exposures. It was pointed out that the BCRA did not take account of the support provided to an exposure by credit enhancement or the credit quality of the underlying exposures.

Many respondents argued that the definition of resecuritisations should be amended to exclude (i) the retransferring of single securitisation exposures, (ii) transactions with small percentages of securitisation exposures (eg. existing CLOs with 5% securitisation buckets) and/or (iii) certain exposures to multi-seller ABCP conduits.

What Happens Next?

The Basel Committee indicated in the Consultation Paper that it would consider the comments received, together with the results of the QIS, before determining the next steps in revising the securitisation framework. We anticipate that it will take some time for the Basel Committee to review the comments and to consider whether to revise the proposals and if so, in what manner. Respondents requested a further consultation period in relation to any revised proposals and an additional QIS.

In light of the significance of securitisation as a funding source,²¹ it will be extremely important to many market participants that a solution is found which sets regulatory capital requirements in a way that allows the securitisation market to function properly and prudently. It is clear from the comments on the proposals that the effects on end users and the economy should also be taken into consideration.

We expect that banks will be monitoring any further developments with a view to detailed consideration of the impact on their capital requirements. In addition, the proposals in the Consultation Paper are only one aspect of the ongoing regulatory changes in relation to capital requirements. Banks will also need to take into account the requirements of Basel III/CRD IV.²² Notable recent developments include the revised liquidity coverage ratio requirements

²¹ We note in particular that the recent Green Paper entitled "Long-Term Financing of the European Economy" published by the European Commission on 25 March 2013 recognised the value of securitisation transactions as a source of long-term finance and raised the question of how the EU securitisation market can be revived.

²² The directive on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (the "Directive") and the regulation on prudential requirements for credit institutions and investment firms (together, "CRD IV"), which bring the Basel III capital adequacy standards into effect under European law. CRD IV was adopted by the European Parliament on 16 April 2013 but is subject to formal approval by the Council of Ministers. The Directive will need to be implemented under national law. The Financial Conduct Authority and the Prudential Regulation Authority stated on 16 April 2013 that they will be carrying out two consultations, and are currently planning on the basis that the Directive will be implemented on 1 January 2014.

published in January 2013²³ and the proposed supervisory framework in relation to large exposures.²⁴

It will therefore be vital for market participants to consider carefully the effects of further developments in relation to the securitisation framework, together with other changes to the regulatory landscape, with a view to the potential implications for the securitisation industry.

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Please feel free to contact any of the following Cadwalader lawyers if you have any questions about this Clients & Friends Memo.

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²³ "Basel III: the Liquidity Coverage Ratio and liquidity risk monitoring tools" - see <http://www.bis.org/publ/bcbs238.pdf>. The revisions include an amendment to the definition of "high quality liquid assets" ("HQLA"), which must be held by banks as a buffer in relation to a 30 calendar day liquidity stress scenario, by the addition of a new Class 2B (which may be up to 15% of the HQLA), which may include certain residential mortgage backed securities rated AA or higher, subject to a 25% haircut. Although banks may view this as positive, various conditions will restrict the availability of this basket within the buffer, and other asset-backed securities are not included.

²⁴ See the Consultative Document entitled "Supervisory framework for measuring and controlling large exposures" published by the Basel Committee on March 2013, which can be found at <http://www.bis.org/publ/bcbs246.pdf>.