The new BCBS securitisation framework

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Introduction

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- **Basel Workstream Securitisations**
- **EBA Subgroup on Securitisations & Covered Bonds**
- **Dutch Covered Bond legislation (together with Ministry of Finance and DACB)**

At Supervisory Policy department (Toezicht beleid).
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Overview

- **Background and objectives**
- **Current framework**
- **Recent progress in Basel workgroup and future timelines**
- **New proposed framework (general aspects*)**
- **Discussion/questions**

** Currently under development in the Basel Committee, to find their way into new legislation in the intermediate term Therefor only general aspects and points of attention can be discussed at the moment.*

Background and objectives (1/2)

Background

During the financial crisis of 2007, several pivotal flaws in the current framework surfaced:

- **Blind reliance on external Credit Ratings:**
  - **many investors had no idea of the risks of the securitisation pieces they were holding, and on top of that**
  - **failure of those ratings to adequately reflect the risks**
- **Cliff effects in assigning capital charges**
- **Too low capital charges for high rated senior tranches**
- **Too high capital charges for low rated tranches**

Background and objectives (2/2)

For the past 3 years, the Ratings & Securitisations workstream has been working on a fundamental revision to the Basel securitisations framework.

Objectives

Revise the Basel framework in securitisations to incorporate the mentioned lessons:

- **Reduced mechanistic reliance on external Credit Ratings**
- **Reduce cliff effects**
- **Increase risk-sensitivity***
- **Higher capital charges for high rated senior tranches**
- **Lower capital charges for low rated tranches**

*Although this should be balanced against pro-cyclicality and complexity…

Current framework

Main characteristics

- **The 2 main formulas are the Ratings Based Approach (RBA) and the Supervisory Formula Approach (SFA)**
  The SFA uses input that only IRB banks will be able to calculate (PD's and LGDs)

- **Different hierarchy for SA and IRB Banks**
- **Both hierarchies have the Ratings Based Approach (RBA) on top**
  Emphasis is clearly on using external ratings in both hierarchies.

- **Floor of 7% risk weight (RW)**
  This result in a minimum capital charge of 0,56%.

- **Overall cap for originators (only in CRD)**
  No more capital is required than would have been required for the underlying pool.

Recent progress in Basel workgroup and future timelines (1/3)

Consultation Paper *(December 2012)*

- **One hierarchy for SA and IRB Banks**
- **Floor of 20% RW**

  This is almost a tripling from the current floor, and result in a minimum capital charge of 1,6%.

For comparison: current average default in Dutch mortgage pools is less than half of that.

- **Two caps: the overall cap & the RW cap**

  Overall cap same as in current (CRD) framework

  RW cap states that seniors don't require a higher RW than the underlying pool.

Intuition: Because the senior tranche is protected by the Credit Enhancement, it is unnecessary to assign this tranche a higher RW than that of the pool (which doesn't enjoy Credit Enhancement).

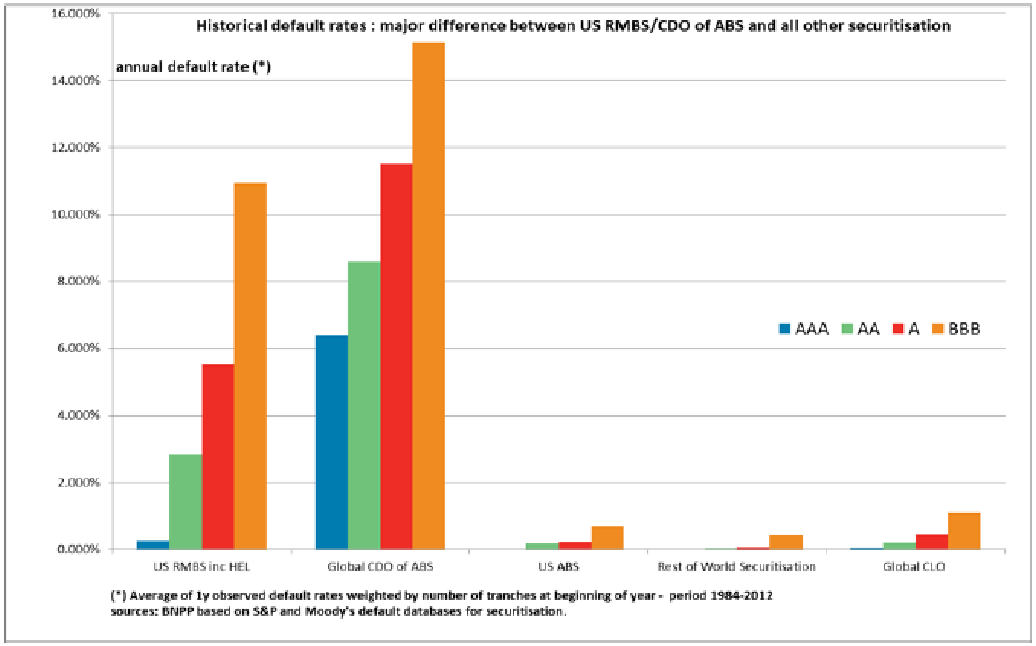
- **Overall RWs increase.**
- Higher RW's for higher rated tranches, Lower RW's for low rated tranches.
- Unweighted average increase of 400%.

Recent progress in Basel workgroup and future timelines (2/3)

Feedback

- Industry unpleasantly surprised by increased RW's
- Complexity, as well as lack of risk-sensitivity, are the main points of criticism

Richard Hopkin (managing director at Association of Financial Markets in Europe):
"Once again, policy makers have fallen in the trap of viewing all securitisations like sub-prime RMBS."



Fitch (Credit Rating Agency):
"The proposal (….) is inconsistent with the strong performance of most structured finance securities. We believe the proposed capital treatment could significantly dent appetite for securitised debt among banks.

Recent progress in Basel workgroup and future timelines (3/3)

Future timelines

- **Second CP will be published at the end of this year**
- **Because we made quite some changes, there might be another QIS**
- **After finalization of the framework, European implementation by means of Technical Standards will still have to proceed via the European Banking Authority, at the mandate of the European Commission.**

New proposed framework

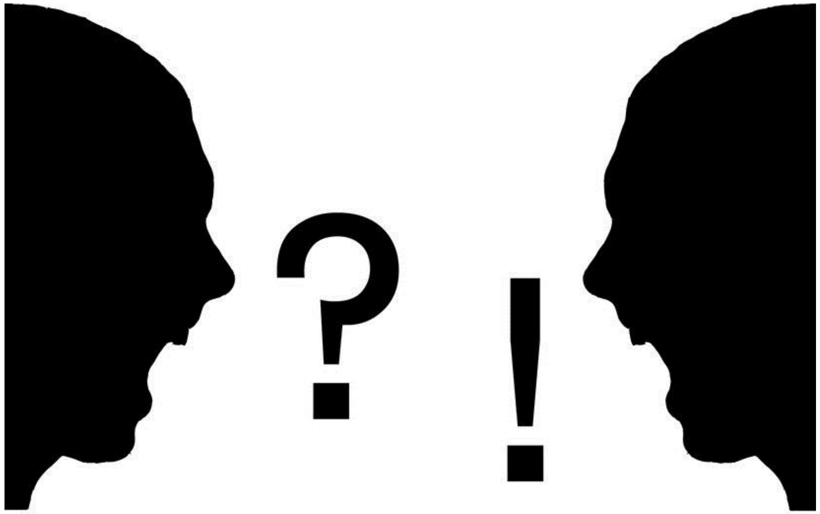
High level changes compared to Consultation Paper

- **Calibration will be lowered**
  (still higher than is the case in current regulation)

- **Complexity will be reduced**

Trade off between risk-sensitivity, and pro-cyclicality and complexity, is not easy…

Discussion/questions



LCR

Discussion was on the 80% LTV limit 'at issuance‘; would this be issuance of mortgages or RMBS? Basel is looking to publish a FAQ on end of this year. DNB is working to make this that it concerns <u>issuance of RMBS</u>.

<u>Basel text (Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, page 14 and 15):</u>

Residential mortgage backed securities (RMBS) that satisfy all of the following conditions may be included, subject to a 25% haircut:
• not issued by, and the underlying assets have not been originated by the bank itself or any of its affiliated entities;
• have a long-term credit rating from a recognised ECAI of AA or higher, or in the absence of a long term rating, a short-term rating equivalent in quality to the long-term rating;
• traded in large, deep and active repo or cash markets characterised by a low level of concentration;
• have a proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions, ie a maximum decline of price not exceeding 20% or increase in haircut over a 30-day period not exceeding 20 percentage points during a relevant period of significant liquidity stress;
• the underlying asset pool is restricted to residential mortgages and cannot contain structured products;
21 In the event of split ratings, the applicable rating should be determined according to the method used in Basel II’s standardised approach for credit risk. Local rating scales (rather than international ratings) of a supervisor-approved ECAI that meet the eligibility criteria outlined in paragraph 91 of the Basel II Capital Framework can be recognised if corporate debt securities or covered bonds are held by a bank for local currency liquidity needs arising from its operations in that local jurisdiction. This also applies to Level 2B assets.
22 As with all aspects of the framework, compliance with these criteria will be assessed as part of peer reviews undertaken under the Committee’s Regulatory Consistency Assessment Programme.
Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools 15
• the underlying mortgages are “full recourse’’ loans (ie in the case of foreclosure the mortgage owner remains liable for any shortfall in sales proceeds from the property) and have a maximum loan-to-value ratio (LTV) of 80% on average at issuance; and
• the securitisations are subject to “risk retention” regulations which require issuers to retain an interest in the assets they securitise.