MAYER • BROWN

Article

This article was first published in *IFLR* on 19 January 2015 – www.iflr.com

ONE RULE, TWO RESULTS

By Kevin Hawken, Carol Hitselberger and Jason Kravitt

The revised securitisation framework will affect EU and US banks differently and may be impacted by the qualifying securitisation concept.

On December 11, the Basel Committee on Banking Supervision (BCBS) published new international model rules for banks' calculation of credit risk capital requirements for exposures to securitisation transactions (Revised Framework). Its publication follows more than two years of work by the BCBS staff and two rounds of public consultation, and represents an important addition to securitisation's new regulatory environment.

On the same day, a joint task force on securitisation markets led by the BCBS and International Organisation of Securities Commissioners (Iosco) published a consultative document on 'Criteria for identifying simple, transparent and comparable securitisations' (STC-CD). Though the STC-CD does not propose regulatory changes, European authorities have already adopted – and are considering further – measures to provide relatively favourable regulatory treatment for securitisations meeting specified criteria. This developing concept of qualifying securitisation may result in further changes to the Revised Framework or affect its implementation by member countries.

The bank capital frameworks in effect in the US and EU differ in some important ways, as do their securitisation markets. As a result, US and EU banks will see different results from implementing the Revised Framework. They and their regulators are also likely to have some different views on the qualifying securitisation concept as it may be applied to bank capital requirements.

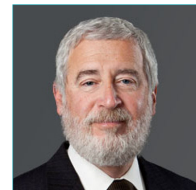
The Revised Framework will replace the prevailing securitisation bank capital rules set out in the amended Basel II framework. It must be implemented by BCBS member countries by the beginning of 2018.

An element of note is the simplified hierarchy of approaches. Under this system, to determine the credit risk capital requirement for a securitisation position, a bank will apply:

- an internal ratings-based approach (IRBA) using a supervisory formula to calculate required capital based on the capital requirement determined under the Basel II internal ratings-based approach (IRB) for the underlying exposures and other attributes of the securitisation position and those exposures;
- where permitted, an external ratings-based approach (ERBA) which specifies risk weights based on qualifying credit rating agency ratings and other variables. For an unrated exposure to asset-backed commercial paper conduit, the internal assessments approach (IAA) from the IRB applies; or
- a standardised approach (SEC-SA), which determines risk weights using a less complicated formula based on the capital charge determined under the Basel II standardised approach (SA) for the underlying exposures and other variables.

Kevin Hawken
Partner, London
E: khawken@mayerbrown.com
T: +44 20 3130 3318

Carol Hitselberger
Partner, Charlotte
E: chitselberger@mayerbrown.com
T: +1 704 444 3522



Jason Kravitt
Partner, New York
E: jkravitt@mayerbrown.com
T: +1 212 506 2622

If the bank cannot apply any of these approaches, then generally it must assign a 1250% risk weight to the position.

The minimum risk weight will be 15%. Under both the IRBA and the ERBA, securitisation positions with longer maturities (from one year to five years) will have higher capital requirements. Tranche maturity will be based on mandatory contractual cash flows of the securitisation tranche rather than contractual or expected cash flows of the underlying assets.

Capital requirements under the Revised Framework for relatively high quality securitisation tranches (and especially those not having short contractual maturities) are expected to generally be substantially higher than under the Basel II IRB.

Qualifying securitisation criteria

The BCBS/Iosco task force was established in May 2014 with a mandate to review the global securitisation markets and suggest improvements. The STC-CD sets out 14 principles (some with several sub-parts) of 'simple, transparent and comparable' securitisations that 'could contribute to building sustainable securitisation markets.' It does not propose any changes to regulations, but notes that the BCBS's introduction to the Revised Framework refers to the STC-CD and states that in 2015 it will 'will consider how to incorporate such criteria into the securitisation capital framework.'

In the EU, the European Banking Authority has just completed a consultation on criteria for 'simple, standard and transparent' securitisation which, it suggests, may be given more favourable treatment under the EU's version of bank capital rules. The European Commission has already adopted regulations that set out criteria for securitisations to be given favourable treatment for the purposes of insurance and reinsurance companies' capital requirements (Solvency II), and for the EU's version of the Basel III liquidity coverage ratio.

Many questions remain about the formulation and application of these qualifying securitisation criteria, and how compliance with them will be determined. It appears likely, however, that some version of this concept will be built into the EU bank capital framework, and that it will be considered for adoption in the international framework and in US rules, though its prospects there are uncertain.

US-EU divergence

The most important difference between the US and EU versions of the Basel II capital framework is that US banks cannot use external credit ratings to determine capital requirements. Accordingly, US banks will not be able to use the ERBA or IAA. This causes concern because the SEC-SA is much less risk-sensitive. On the other hand, US banks have wider latitude to apply the IRBA, so they may be able to apply the IRBA more often than EU banks could when acting as investors.

The US securitisation market has always been much wider and deeper than the EU's, and while it has largely recovered since the financial crisis (except for non-agency residential mortgage-backed securities), the EU market continues to struggle. For banks as well as regulatory authorities in the US, favourable treatment for qualifying securitisations could provide some benefit, but its adoption could also risk disrupting a market that is already recovering well. In the EU, however, its implementation is seen as necessary to help the market recover and bring in new investors, and in turn to help revitalise the wider economy. EU banks, investors and regulators therefore embrace the concept with more enthusiasm and see it as important not just for capital and liquidity ratios, but for other regulatory purposes.

The financial industry and regulatory communities will devote much effort to defining and applying qualifying securitisation to improve regulation, without raising barriers and distorting competition between different markets.

By Mayer Brown partners Kevin Hawken in London, Carol Hitselberger in Charlotte, and Jason Kravitt in New York.

Mayer Brown is a global legal services provider advising many of the world's largest companies, including a significant portion of the Fortune 100, FTSE 100, DAX and Hang Seng Index companies and more than half of the world's largest banks. Our legal services include banking and finance; corporate and securities; litigation and dispute resolution; antitrust and competition; US Supreme Court and appellate matters; employment and benefits; environmental; financial services regulatory and enforcement; government and global trade; intellectual property; real estate; tax; restructuring, bankruptcy and insolvency; and wealth management.

Please visit www.mayerbrown.com for comprehensive contact information for all Mayer Brown offices.

Mayer Brown is a global legal services provider comprising legal practices that are separate entities (the "Mayer Brown Practices"). The Mayer Brown Practices are: Mayer Brown LLP and Mayer Brown Europe-Brussels LLP, both limited liability partnerships established in Illinois USA; Mayer Brown International LLP, a limited liability partnership incorporated in England and Wales (authorized and regulated by the Solicitors Regulation Authority and registered in England and Wales number OC 303359); Mayer Brown, a SELAS established in France; Mayer Brown JSM, a Hong Kong partnership and its associated legal practices in Asia; and Tauil & Chequer Advogados, a Brazilian law partnership with which Mayer Brown is associated. Mayer Brown Consulting (Singapore) Pte. Ltd and its subsidiary, which are affiliated with Mayer Brown, provide customs and trade advisory and consultancy services, not legal services.

© 2015 The Mayer Brown Practices. All rights reserved.