Proposed Revisions to Basel Securitisation Framework

In December 2012 the Basel Committee on Banking Supervision (BCBS) published a consultation paper (BCBS 236)[1] proposing substantial changes to the methods banks use to calculate risk-based capital requirements related to securitisation exposures (Proposal). The Proposal's stated objectives are to make securitisation capital requirements more prudent and risk-sensitive, to lessen reliance on external credit ratings, and to reduce "cliff effects" (in which small differences in credit quality or other parameters produce large differences in capital requirements). Comments on the Proposal are due 15 March 2013.

The Proposal would change the securitisation framework within the Basel II bank capital requirements framework (Basel II)[2] that BCBS adopted in 2004 and to which it made some amendments, collectively known as Basel II.5,[3] following the financial crisis of 2008. The member states of the European Union and many other countries have already implemented Basel II and Basel II.5 and are in the process of adopting and implementing Basel III.[4] The United States, however, never fully implemented Basel II, and in 2012 its bank regulators proposed rules to implement modified versions of Basel II and II.5 as well as Basel III.[5] Some elements of the Proposal resemble elements of the US proposed rules.

Highlights of the proposal are as follows:

- BCBS is considering two alternative hierarchies of approaches for determining risk weights of securitisation exposures. The two alternative hierarchies (Alternative A and Alternative B) are significantly different from each other and from those included in the standardised approach (SA) and the internal ratings-based approach (IRB) under the Basel II securitisation framework.
- BCBS has proposed, for both alternative hierarchies, a revised ratings-based approach (Revised RBA or RRBA) based on the ratings-based approach (RBA) used in the Basel II IRB, a modified supervisory formula approach (MSFA) based on the supervisory formula approach (SFA) used in the Basel II IRB, and a simplified supervisory formula approach (SSFA) similar to that included in the US proposals.
- Both alternative hierarchies also make use of "concentration ratio" approaches based on risk weights of the underlying securitised exposures. Under Alternative B, a concentration ratio approach (CR_{KIRB}) based on the weighted average risk weights of underlying exposures determined under the IRB (K_{IRB}) would be used to determine securitisation risk weights of exposures other than senior high-quality exposures. Under both alternative hierarchies,

1 BCBS, Revisions to the Basel Securitisation Framework – Consultative Document (Dec. 2012), available at http://www.bis.org/publ/bcbs236.htm.

2 BCBS, Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version (Jun. 2006), available at http://www.bis.org/publ/bcbs128.htm (Basel II).

3 BCBS, Enhancements to the Basel II framework (Jul. 2009), available at http://www.bis.org/publ/bcbs157.htm; BCBS, Revisions to the Basel II market risk framework – final version (Jul. 2009), available at http://www.bis.org/publ/bcbs158.htm (BCBS 158); Mayer Brown, Basel II Modified in Response to Market Crisis (Jul. 2009), available at http://www.mayerbrown.com/publications/Basel-II-Modified-in-Response-to-Market-Crisis-07-23-2009/.

4 BCBS, Progress report on Basel III implementation (update published in Oct. 2012), available at http://www.bis.org/publ/bcbs232.htm.

5 Board of Governors of the Federal Reserve System (FRB) and others, Notice of Proposed Rulemaking (NPR): Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action (Jun. 2012), NPR: Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements (Jun. 2012), and NPR: Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule (Jun. 2012), all available at http://www.federalreserve.gov/aboutthefed/boardmeetings/20120607openmaterials.htm; Mayer Brown, Federal Reserve Board Approves Basel III Proposals and Market Risk Capital Rule (Jun. 2012), available at http://www.mayerbrown.com/Federal-Reserve-Board-Approves-Basel-III-Proposals-and-Market-Risk-Capital-Rule-06-08-2012/.

a backstop concentration ratio approach (BCRA) based on risk weights of underlying exposures determined according to the SA (K_{SA}) would be used to determine risk weights of exposures where other methods could not be used, as a backstop before applying a risk weight of 1250%. A similar concentration ratio approach, based on risk weights determined under the revised securitisation framework, would be used to determine risk weights of all re-securitisation exposures.

- Securitisation exposures would have a minimum risk weight of 20%, rather than 7% as under the Basel II IRB. Re-calibration of the ratings-based and supervisory formula approaches would result in higher risk weights for high credit quality exposures and lower risk weights for some lower credit quality exposures. The concentration ratio approaches, when applied to securitisation approaches other than the most junior tranches, result in relatively high-risk weights because they do not take account of the credit protection provided by the junior tranches.
- Under both the MSFA and the RRBA, risk weights would vary according to maturity of the securitisation exposure (and not just the underlying exposures), with a minimum of one year and a maximum of five years. For this purpose, the tranche maturity would be determined based on mandatory contractual cash flows of the securitisation tranche rather than those of the underlying assets. So, for an asset-backed security with a typical "pass-through" structure, the maturity would be the legal final maturity (which typically falls up to two years later than the latest contractual maturity of the underlying assets).
- BCBS will conduct a quantitative impact study (QIS) on the Proposal beginning during the period for comments on the Proposal and will consider the comments and QIS results in formulating a revised securitisation framework.

Alternative hierarchies

Under Alternative A, for a bank to determine the risk weight of any securitisation exposure:

- If the bank had supervisory permission and sufficient information to determine IRB risk weights for all underlying exposures, it would apply the MSFA.
- If the bank could not use the MSFA, then, according to the method chosen by the relevant jurisdiction, the bank would apply either (a) the RRBA (or, if applicable, the internal assessment approach (IAA) provided in the Basel II IRB for securitisation exposures to asset-backed commercial paper (ABCP) conduits) or (b) the SSFA.
- If the bank could not use the second approach adopted in its relevant jurisdiction, then it would apply the BCRA.
- If the bank could not apply the BCRA, it would assign a risk weight of 1250%.

Under Alternative B, for a bank to determine the risk weight of any securitisation exposure:

- The bank would first determine whether the exposure was a senior high-quality exposure, that is, an exposure that was senior to or pari passu with all other exposures in the securitisation and had a very high credit quality (corresponding to a credit rating agency (CRA) rating of AAA to AA- or A1/P-1/F-1). If the bank could not determine that the exposure was senior high-quality, the bank would treat it as other than senior high-quality.
- For senior high-quality exposures, the bank could choose to apply either the RRBA (or, in an appropriate case, the IAA) or the MSFA (or, if it could not use the MSFA and if bank supervisors in the relevant jurisdiction permitted, the SSFA). The bank's decision as to which approach to use would be based on an internal policy not primarily intended to minimise capital requirements, and should not be changed over time without adequate justification.
- For securitisation exposures other than senior high-quality exposures, if the bank had supervisory permission and sufficient information to calculate K_{IRB} for each underlying exposure, the bank would use CR_{KIRB}.
- For a senior high-quality exposure, if the bank could not apply the MSFA (or IAA) or SSFA, as applicable, and for any other securitisation exposure, if the bank could not use CR_{KIRB}, then it would use BCRA.
- If it could not use any other method, the bank would apply a risk weight of 1250%.

The new and modified risk weight methods are as follows:

Modified Supervisory Formula Approach (MSFA)

The MSFA is based on the SFA in the Basel II IRB, but is modified to take into account maturity of the securitisation exposure (as well as maturity of the underlying exposures), and further recalibrated to make it more conservative.

Like the current SFA, the MSFA could be used only by banks having an IRB risk weight model approved by their banking supervisors, as well as information sufficient to estimate relevant parameters, including probability of default (PB), exposure at default (EAB) and loss given default (LGD), used to determine K_{IRB} with respect to the underlying exposures. BCBS proposes that a bank can use the MSFA for a securitisation exposure only if the bank can estimate those parameters for every underlying exposure. It is also considering whether the approach should be available to "foundation" IRB banks that do not estimate underlying loans' LGD.

BCBS expects and intends capital requirements under the MSFA generally will be somewhat higher than under the SFA, because the MSFA would take account of tranche maturity based on contractual cash flows and because BCBS would recalibrate two "supervisory add-ons", tau (reduced from 1000 to 100) and omega (reduced from 20 to 10) in order to add prudence and reduce cliff effects.

Revised Ratings Based Approach (Revised RBA or RRBA)

The RRBA, like the ratings matrix under the Basel II IRB, assigns risk weights to rated securitisation exposures based in part on qualifying CRA ratings, assigning values to each rating level from AAA to CCC- and below. However, the RRBA takes into account not only the exposure's credit rating and whether the exposure is the most senior tranche, but also the exposure's thickness (the ratio of the tranche amount to the sum of all tranches in the securitisation) and its maturity (between one and five years as described above). (On the other hand, the RRBA drops the RBA distinction between granular and non-granular exposures, which BCBS said was not clearly correlated with default risk of securitisation exposures.) To handle the extra variables, the RRBA uses formulas rather than a single ratings table. Banks would use the same RRBA whether they used the SA or the IRB to determine risk weights for the underlying exposures. In Alternative B, however, banks could apply the RRBA only to senior high-quality exposures (which would be thick senior exposures rated AAA to AA- (or A-1/P-1/F-1)), so a simplified version of the RRBA would cover the limited range of variables and outcomes.

To apply the RRBA to a securitisation exposure, the exposure would need to have at least two qualifying CRA ratings, and the bank would apply the second-best rating. In the case of an unrated exposure that was senior to a rated exposure, a bank (whether it used the SA or the IRB for the underlying exposures) could use an inferred rating under the same conditions as in the Basel II IRB.

The lowest risk weight under the RRBA, as under the revised framework generally, would be 20%, rather than 7% as under the Basel II RBA. Risk weights would be higher for tranches with longer tenors (for example, 58% rather than 7% or 20% for a senior AAA tranche with maturity of five years or more). On the other hand, 1250% risk weights would apply only to tranches rated below CCC- or unrated and thinner tranches rated BB or lower, rather than to all tranches rated B+ or lower as under the existing RBA.

Simplified Supervisory Formula Approach (SSFA)

The SSFA is similar to the SSFA included in the US proposals. It would determine the risk weight of a securitisation exposure using a formula based on the weighted average capital charge determined under the SA for the underlying exposures (K_{SA}), the ratio of delinquent underlying exposures to their ending balance, the attachment point of the securitisation exposure (at which losses would first be allocated to the exposure), its detachment point (at which the exposure would be a total loss), and a supervisory calibration parameter (p). Subject to the QIS results, BCBS proposes to set the parameter p at 1.5, which would result in higher capital requirements than in the US proposal (in which p was set at 0.5 for ordinary securitisation exposures and 1.5 for re-securitisation). While the US proposal specified that data used in the calculation must be the most currently available and not more than 91 days old, the BCBS Proposal does not address this point. BCBS says the SSFA is designed and calibrated to produce capital requirements broadly in line with, but slightly higher than, the MSFA.

Concentration ratio approaches

The concentration ratio method based on K_{IRB} (CR_{KIRB}) is based on an approach used in the Basel II.5 revisions to the market risk framework.[6] It is also similar to the "look through" method provided in the Basel II SA, as modified in the European Union Capital Markets Directive (CRD) to apply to both senior and non-senior exposures,[7] but it could be used only by banks that had supervisory permission and information sufficient to calculate K_{IRB} with respect to the underlying exposures. Under this method, the risk weight of a securitisation exposure would equal the lesser of (a) 1250% and (b) 12.5 times (i) the weighted average capital requirement of the underlying exposures determined according to the IRB (K_{IRB}) divided by (ii) the detachment point (D). This formula, like the other "concentration ratio" approaches, "grosses up" risk weights of non-senior tranches to reflect the allocation of losses to all non-senior tranches, but does not give credit to the credit protection provided by tranches subordinated to the tranche being measured.

In both alternative hierarchies, if no other method applied, a bank would determine the risk weight of a securitisation exposure by applying the BCRA. The BCRA is similar to CR_{KIRB} except that (a) it would be based on the weighted average capital charge determined according to the SA (K_{SA}) rather than according to the IRB, and (b) the product 12.5 times K_{SA}/D would be further multiplied by a factor F, which would equal 1 for a senior exposure and 2 for any non-senior exposure. That is, for any non-senior exposure, the BCRA would double the grossed-up risk weight that would otherwise apply.

For re-securitisation exposures, none of the other methods would apply, and risk weights would have to be determined according to a concentration ratio approach, similar to BCRA except that (a) it would be based on risk weights determined under the revised securitisation framework (which would not have separate SA and IRB rules for securitisation risk weights), and (b) the factor F would equal 1 (because in BCBS's view the risk weights of securitisation exposures under the revised framework would be conservative enough).

6 BCBS 158, para. 712(vi)(c).

7 Directive 2006/48/EC of the European Parliament and of the Council of 14 Jun. 2006 relating to the taking up and pursuit of the business of credit institutions (recast, as amended), Annex VII Part 4 points 9-10, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0048:20100330:EN:PDF.

Other changes and clarifications

The Proposal also sets out further changes and clarifications:

- The MSFA and RRBA would take into account maturity (M) of a securitisation exposure based on contractual cash flows of that exposure and not according to performance of (or contractual cash flows of) the underlying assets. For a pass-through tranche, M would equal the legal final maturity (but not less than one year nor more than five years). For committed facilities related to a securitisation exposure, M would equal the term of the commitment plus the maturity of the exposure. For certain types of credit enhancement facilities that are exposed to losses only during the stated commitment period, M would be the commitment period.
- The minimum risk weight for any securitisation exposure would be 20% (except in an unusual case where the risk weight of the underlying assets, if held by the bank directly, would be less than 20%).
- The revised framework would eliminate certain special provisions of the Basel II securitisation framework, namely the SA look-through approach for second loss positions in ABCP programmes,[8] the IRB limited look-through for ABCP liquidity facilities,[9] the SA 50% conversion factor for "eligible" liquidity facilities,[10] and the early amortisation provisions for revolving credit pools[11] (which the Proposal would treat as non-securitised).
- Write-downs and purchase discounts would be used to reduce the notional amount of an exposure to which a risk weight applied, but would not be deducted directly from a bank's capital requirement.

The Proposal includes some other changes and clarifications that banks may view as relatively favourable:

- A bank's capital requirement for a retained securitisation exposure will not be higher than the amount of capital it would be required to maintain if it held all the underlying exposures directly. This is consistent with the existing Basel II rule under the IRB,[12] but the Proposal says it will apply also under the SA to banks acting as originators and sponsors.

8 Basel II paras. 574-75.

9 Basel II para. 639.

10 Basel II paras. 576, 579.

11 Basel II paras. 590-605.

12 Basel II para. 610.

- For a senior securitisation exposure, a bank could apply a look-through approach to determine the maximum risk weight based on the weighted average risk weight of the underlying exposures. While this look-through exists in the Basel II SA,[13] under the Proposal it would apply to rated as well as unrated securitisation exposures, and whether the risk weights of the underlying exposures were calculated under the IRB or the SA.
- A bank that used the SA, and not only one using the IRB, to determine risk weights of underlying exposures could use inferred ratings (credit ratings of a junior rated tranche)[14] to determine the risk weight of a more senior unrated securitisation exposure.
- An originator would no longer be required (as under the Basel II SA)[15] in all cases to deduct below-investment-grade retained exposures.

Assumptions and calibration

BCBS stated that its assumptions and techniques for developing and calibrating the MSFA and the RRBA will be addressed further in a technical note. Its guiding principles include enhancing consistency between the securitisation framework and the general IRB framework in order to reduce arbitrage (and in particular, to rectify certain assumptions about diversification benefits of securitisation). It also assumed that CRA ratings for securitisation and corporate exposures imply similar loss rates. In focussing on the credit quality of underlying exposures, BCBS assumed that, for securitisation exposures having a given CRA rating level, the underlying exposures have a substantially lower credit quality.[16] The MSFA and RRBA use similar assumptions as to credit quality, with certain adjustments to account for differences between the formulas used in the two approaches. The methods and calibrations based on these assumptions result in a significant increase in risk weights for senior tranches, and a reduction in risk weights and reduction of "cliff effects" for some junior tranches.

Consultation and QIS to follow

BCBS will conduct a QIS beginning during the comment period to inform its decisions and calibration of the revised securitisation framework based on the Proposal. It seeks feedback on, among other things, the different effects of the two alternative hierarchies, conditions to application of the different approaches and the formulation and calibration of the new and revised approaches.

Questions

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13 Basel II paras. 572-73.
14 Basel II paras. 617-18.
15 Basel II paras. 569-70.
16 For tranches rated BB or better, BCBS set the assumed weighted average PD and LGD of underlying exposures at 4.73% and 60% (corresponding to historical corporate bonds rated B, with appropriate stress loss severity); BCBS 236 part V text accompanying note 38.

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