



Australian Securitisation Forum

**Submission to the
Australian Prudential Regulation Authority
regarding the**

**Basel Working Paper on the Treatment of Asset
Securitisations (October 2001)**

15 November 2001

1. Introduction

- 1.1. This submission contains a response by the Australian Securitisation Forum (ASF) to the Basel Committee on Banking Supervision's (Basel Committee) Working Paper on the Treatment of Asset Securitisations, dated October 2001 (Working Paper).
- 1.2. The ASF wishes to table this submission with the Australian Prudential Regulation Authority (APRA) for its consideration when corresponding with the Basel Committee in relation to the Working Paper.

2. The Australian Securitisation Forum

- 2.1. The Australian Securitisation Forum (ASF) is the peak body representing the securitisation industry in Australia. It has been in existence for over 10 years and its purpose is to promote the development of securitisation in Australia.
- 2.2. The ASF's members include representatives from major banks, investment banks, insurers, rating agencies, trustees and legal and accounting firms.
- 2.3. A sub-committee of the ASF was formed to consider the Working Paper and to prepare this Submission. A list of member organisations of that sub-committee is attached as Appendix A.

3. Summary

- 3.1. The ASF fully supports the guiding principle outlined in the Working Paper which states that "the IRB approach should be neutral with regard to the capital requirements it produces in order not to create incentives or disincentives for Banks to engage in securitisations".
- 3.2. The ASF considers that the Working Paper falls short of achieving its own guiding principle because of conservative measures such as the ABS scaling factors and requiring capital in excess of K_{IRB} . The ASF believes that any approach that results in an increased capital requirement creates clear disincentives for banks to become involved in securitisation.
- 3.3. The ASF believes the scaling factors proposed by the Basel Committee are unnecessarily conservative. The ASF considers that structured ratings adequately address the credit risk of asset backed securities, including additional structural factors such as excess spread. The continuous market discipline imposed by structured ratings mitigates any need for "conservatism" from the Basel Committee. If the credit outlook for a class of securities deteriorates significantly over time, market discipline will ensure that the rating is changed accordingly.
- 3.4. The ASF strongly disagrees with the proposal to hold capital in excess of K_{IRB} under the supervisory formula approach. The ASF similarly disagrees with the use of a premium factor in the supervisory formula because it will result in capital being held in excess of K_{IRB} . In both instances, the ASF argues that credit risk is not increased by securitisation.

4. Specific Comment

4.1 ABS RISK WEIGHTS

- 4.1.1 The ASF supports the introduction of a framework that allows banks to rely on external ratings within the Foundation IRB approach and welcomes the removal of an imposed 100% LGD assumption. However, further modifications are required to achieve the stated objective of not creating a disincentive for banks to engage in securitisation.
- 4.1.2 The arguments supporting the multiplicative factors for ABS are flawed and result in a capital charge that is not aligned with corporate exposures of similar risk.

- 4.1.3 Scaling factors greater than 1.0 are inconsistent with ratings methodology. Moody's ratings are based on expected loss which explicitly takes into consideration probability of default and loss given default, for both corporate and ABS exposures.
- 4.1.4 Diversification. The blanket assumption that asset pooling purges idiosyncratic risk so ABS investments do not contribute as significantly to diversification is incorrect. Idiosyncratic risk remains in many ABS investments, particularly those ranking lower in priority, which may incur loss upon occurrence of a single or few defaults. ABS investments can also add diversification with investments across asset classes and geographies and give banks access to exposures otherwise unattainable. It is also relevant to point out that corporate ratings may take the degree of asset diversification within the corporate into account. Therefore, the benefits of diversification are neither typical or unique to ABS.
- 4.1.5 The ASF believes that the rating of an exposure takes LGD into account and therefore ABS scaling factors are not necessary. To the extent that the Basel Committee is concerned with the LGD of lower rated ABS exposures, then at the same time it should recognise that highly rated senior ABS exposures should receive a scaling factor of less than 1.
- 4.1.6 Maturity adjustments are required to reflect the lower risk of short term exposures such as ABCP. These should be consistent with the framework applied for the corporate exposures under the Foundation IRB approach.
- 4.1.7 Thickness or thinness of tranches are already taken into account when determining the original rating and no further adjustment is required.

4.2 INFERRED RATINGS

- 4.2.1 The ASF believes that the concept of inferred ratings is positive and could assist in the appropriate level of capital allocation for many existing securitisation structures. However, the ASF has a number of qualifications to the proposed application of inferred ratings.
- 4.2.2 First, a rating should be inferred if an exposure ranks pari passu in all respects to the externally rated exposure. This is most relevant in the case of liquidity facilities that may be provided by a bank to a securitisation transaction.
- 4.2.3 Second, the application of an inferred rating should be optional. In particular, where a bank is applying the supervisory formula for exposures within K_{IRB} and the bank, in addition, is holding senior positions for which an inferred rating could be applied (because they rank pari passu with other externally rated exposures) then the bank should be able to choose between applying either an inferred rating or supervisory formula approach to allocate capital for that senior exposure.
- 4.2.4 Third, a rating may be inferred with a minimum of one ECAI and with that exposure being subject to transference to only one other counterparty. We note that in some markets, including the Australian securitisation market, that one ECAI rating is commonplace and the number of individual counterparties participating in an issue is often limited.
- 4.2.5 Inferred ratings should not be limited to banks adopting the IRB approach. The level of analytical sophistication expected of a bank under the IRB approach is not required in order to apply an inferred rating.

4.3 SUPERVISORY FORMULA

- 4.3.1 The ASF supports proposals that provide the ability for originating banks to assess the amount of capital required against the underlying assets, and then adjust that for risk

transferral achieved by securitisation. However, modifications are required to ensure the Committee's objectives are achieved. These are detailed below.

- 4.3.2 For rated exposures (both external and inferred), qualifying/approved banks, both originating and investing, should have the option of selecting whether to use the supervisory formula or the ABS Risk Weights. This should be the case for exposures both less than or greater than K_{IRB} . This will ensure consistency between approaches for both originating and investing banks and will avoid behaviour to arbitrage the two methodologies.
- 4.3.3 The ASF is strongly opposed to the proposal that there be an increased capital holding for retained positions in excess of K_{IRB} as it creates a disincentive to securitise. In particular, it will impose disincentives for banks (both investing and originating) attempting to manage credit risk concentrations on their balance sheet through securitisation techniques. If the Foundation IRB capital holdings are assessed correctly for the underlying assets, the risk post the sale of senior risk tranches will also be adequately captured. Concerns regarding the reliability of K_{IRB} for an underlying asset class should be addressed within the Foundation IRB general framework. The capital requirements of originating banks should be capped at K_{IRB} .
- 4.3.4 Where I/O strips are sold and there is no recourse to the seller, there should be no deduction from capital. It is not an artificial increase in capital.
- 4.3.5 The premium factor set at 0.2 results in a material increase in capital held within the banking system post securitisation, although credit risk on the underlying portfolio does not increase. This produces a disincentive to securitise. The ASF believes that there needs to be some form of capital allocation across the risk spectrum, but the approach adopted by the Basel Committee should not result in system capital substantially exceeding K_{IRB} .
- 4.3.6 The premium factor is inconsistent with the stated objective of achieving capital neutrality and not creating disincentives to securitise. The concept of a premium factor is illogical as the underlying portfolio credit risk is not increased by securitisation. The ASF believes that there does need to be some form of capital allocation across the risk spectrum, but the approach adopted by the Basel Committee should not result in capital exceeding K_{IRB} .
- 4.3.7 The ASF disagrees with concept of a capital floor as it provides disincentives to hold very low risk super senior tranches. As the supervisory formula is recalculated over time, only a material deterioration in the risk of the underlying portfolio will trigger need to provide further capital.

4.4 REVOLVING SECURITISATIONS

- 4.4.1 Transactions containing scheduled amortisations should not attract an increased capital charge provided:
 - 4.4.1.1 principal and interest flows are established at the outset and are in accordance with the economic interests of both originators and investors; and
 - 4.4.1.2 any losses on the underlying assets are allocated on a pro-rata basis for the life of the transaction.
 - 4.4.1.3 For example, it is common for a securitisation of scheduled amortising assets to incorporate a "substitution" period, which may display the same characteristics as described for revolving securitisations. The ASF believes that substitution period, regardless of the length of substitution, should not automatically require a bank to hold capital to K_{IRB} against the securitised assets.

4.5 LIQUIDITY FACILITIES AND CREDIT ENHANCEMENT TO ABCP CONDUITS

- 4.5.1 The ASF regards that the Basel Committee's position on liquidity facilities and credit enhancements for ABCP conduits requires significant further consideration by the industry and the Basel Committee. The ASF is not currently in a position to put forward an industry view on this issue.
- 4.5.2 The ASF believes that because liquidity facilities normally rank pari passu with ABCP holders they should not be considered "second loss" facilities.
- 4.5.3 The provider of liquidity facilities should be able to choose between applying an inferred rating or the supervisory formula to calculate the relevant capital charge.
- 4.5.4 The ASF is uncertain whether the Committee is proposing to assume a 100% EAD for liquidity facilities provided to ABCP conduits. This assumptions would ignore that the fact in some circumstances liquidity facilities may not be drawn and ABCP holders are subject to loss. The ASF believes that the EAD should be consistent with liquidity facilities provided to corporates.

4.6 SYNTHETIC SECURITISATIONS - STANDARDISED TREATMENT

- 4.6.1 The ASF strongly disagrees with the proposed requirement for banks under the standardised approach to hedge retained senior risk in order to obtain capital relief. The market discipline provided by external ratings should be sufficient to provide an inferred rating for banks that adopt either the IRB or standardised approach. Whilst this penalty treatment is intended as an incentive for banks adopting the standardised approach to move to the IRB approach, it also creates a disincentive for these banks to actively mitigate credit risk.
- 4.6.2 Requiring a bank adopting the standardised approach to enter into a further credit derivative provides an added cost disincentive to enter into the synthetic securitisation. In most cases, the bank would enter into the credit derivative for the sole purpose of obtaining a regulatory capital arbitrage.
- 4.6.3 Generally, senior tranches would only be exposed to the catastrophic losses on the underlying asset portfolio. Should catastrophic losses eventuate, a bank will be better off for having entered into the synthetic securitisation than holding the assets on balance sheet. The ASF seeks recognition of this risk transferral within the capital framework.

4.7 SYNTHETIC SECURITISATIONS - OPERATIONAL REQUIREMENTS (IRB AND STANDARDISED)

- 4.7.1 The ASF believes the requirement for dual ratings is unduly conservative. Market discipline should be allowed to dictate the number of ratings a structured transaction requires (i.e. through investor demands).
- 4.7.2 The requirement for a "significant amount" of externally rated exposures to be issued ignores the market discipline the rating represents. An exposure which ranks pari passu to an externally rated tranche should adopt an inferred rating. If the rated tranche is too "thin", it will be subject to higher risk of ratings volatility over time.
- 4.7.3 The ASF believes it is not necessary to prescribe a minimum number of investors in a securitisation transaction.

- 4.7.4 In relation to maturity mismatch, the ASF believes that the Basel Committee should encourage the further development of a dynamic market for hedging credit risk. Mismatch should be tolerable within prescribed maturity bands (without requiring additional capital).

Appendix A

ABN AMRO Australia Limited

Commonwealth Bank of Australia

Macquarie Bank Limited

National Australia Bank Limited

Perpetual Trustees Australia Limited

SG Australia Limited

Westpac Banking Corporation