

Basel II and its implications for Securitisation in Australia

Introduction

The implementation of Basel II in Australia has tremendous implications for the securitisation industry in this country. It has the potential to significantly shape the market, just like the original PSC2 was responsible for the widescale adoption by Australian banks of securitisation.

Basel II is scheduled to come into force at the end of 2007. Transactions closing now are likely to be affected by it and so it is important to start structuring with the new rules in mind so as to produce the optimal economic outcomes after 2007.

New Prudential Standards Implementing Basel II

On 11 April 2005, APRA released a discussion paper on its approach to credit risk and its new proposed Prudential Standard APS112 Capital Adequacy: Standardised Approach to Credit Risk. Written submissions on the proposed new Prudential Standard should be forwarded to APRA by 30 September 2005.

The discussion paper and proposed new Prudential Standard relate to the Standardised Approach. The Basel II Framework also provides for two Internal Ratings Based Approaches ("IRB"), being the Foundation and Advanced Internal Ratings Based Approaches. It is expected that most ADIs will adopt the Standardised Approach, other than for the four majors (St George Bank has also indicated that it wants to adopt the Advanced IRB Approach) and for a number of foreign owned banks (for example, BankWest).

On 28 July 2005 APRA released a draft Prudential Standard in relation to the IRB approach (Prudential Standard APS113 Capital Adequacy: Internal Ratings-based Approach to Credit Risk). Comments on the draft are due by 31 December 2005).

On 28 July 2005 APRA also released a discussion paper introducing the Prudential Standard for the Standardised Approach to operational risk (APS114 Capital Adequacy: Standardised Approach to Operation Risk). Comments on the draft are due by 31 December 2005.

APRA has also flagged changes to APS120 (Securitisation). These are likely to be quite wide-ranging if the Basel II Framework on Securitisation is any indication.

APS112 Capital Adequacy: Standardised Approach to Credit Risk

The following issues under the new APS112 still remain outstanding:

- The draft Prudential Standard does not include Guidance Notes on netting and derivatives in the banking book. It is expected that these Guidance Notes will be completed later this calendar year.
- APRA is giving further policy consideration to the capital charge for margin lending products. Under the Basel II Framework, this is scheduled to drop from 8% to 0% which is unacceptable to APRA.

The three major implications of APS112 on securitisation are as follows:

- The risk weighting of residential mortgage loans.
- The risk weighting of securitised instruments.
- The risk weighting of undrawn commitments.

The Risk Weighting of Residential Mortgage Loans

The draft Prudential Standard provides new risk weightings for residential mortgage loans. APRA has rejected the Basel II Framework for two risk weights of 35% and 100%. The differential was too great and, in APRA's view, created an incentive to circumvent the capital requirements. Also, APRA felt that the increase in

regulatory capital to 100% in one jump at an 80%+ LVR was a disproportionately large increase relative to the greater economic risk.

The new risk weights for residential mortgages are based on LVRs. In APRA's view the historical data shows a "strong significant relationship" between LVRs and the probability of default. APRA also provides for concessional risk weightings where the loan is mortgage insured. These are available if the first 40% of the loan is insured. APRA did not require 100% mortgage insurance in order to be entitled to the concessional risk weighting. In its view, 100% mortgage insurance creates poor risk management incentives. The incentive to evaluate and monitor the loan is reduced when an ADI perceives that there is no risk to it of loss. This also creates "moral hazard" problems (though, this is not explained). Interestingly, under APS 112 there will be no incentive from a capital perspective for ADIs to require 100% mortgage insurance.

The new risk weights are as follows:

Risk-weighting scheme for residential mortgage loans under the standardised approach to credit risk

LVR (%)	Standard loans		Non-standard loans*	
	Risk-weight (no LMI) (%)	Risk-weight (with LMI)** (%)	Risk-weight (no LMI) (%)	Risk-weight (with LMI)** (%)
0-60	35 (50)	35 (50)	50 (no change)	35 (50)
60.01-80	35 (50)	35 (50)	75 (100)	50 (no change)
80.01-90	50 (100)	35 (50)	100 (no change)	75 (50)
90.01-100	75 (100)	50 (no change)	100 (no change)	75 (50)

* Defined as loans not meeting specified criteria; for the most part, this refers to "low-doc" loans.

** A minimum of 40 per cent of the original loan amount must be insured

The current position or risk weighting is indicated in the brackets.

Most of the reductions in capital relate to standard loans, while the position for non-standard loans has either largely remained the same or declined, perhaps reflecting APRA's unease at ADIs participating in low-doc lending.

Overall, ADIs will have to hold less capital for their home loans (in the order, in most case, of approximately 30%). If an ADI participates in securitisation, less capital will be released from the transfer of home loans off its balance-sheet and it will have to hold capital against any interest rate and currency hedges and standby facilities it provides to the securitisation vehicle and against the operational risks of the securitisation. This may lead to there overall being less incentive for such ADI's to securitise. On the other hand, for lesser rated ADIs, their cost of debt may increase (as these will no longer be risk-weighted on their funders' books at 20%) so securitisation may become a more attractive option for them.

Risk Weighting for Securitised Instruments

The new APS112 does not apply to "securitisation exposures". These will be the subject of the requirements of APS120. The expression "securitisation exposures" is the expression used in the Basel II Framework. It includes mortgage backed securities, asset backed securities, credit enhancements, liquidity facilities, interest rate and currency swaps and credit derivatives.

We do know, though, from the Basel II Framework the likely treatment of these categories and the risk weightings likely to be assigned under APS120. We can, therefore, draw some conclusions regarding the impact of Basel II on securitisation, though these still will need to be tentative until the new APS120 is issued.

Under the Standardised Approach the risk weighting for corporate and securitisation exposures will turn on their rating. This must be given by an APRA approved external credit assessment institution (ECAI).

The new proposed risk weightings are as follows:

Rating of Counter-Party (S&P)	Existing Risk Weighting	Proposed New Risk Weighting (APS112)	Basel II Framework Risk Weighting for Securitisation
AAA to AA-	100%	20%	20%
A+to A-	100%	50%	50%
BBB+ to BBB-	100%	100%	100%
BB+ to BB-	100%	100%	350%
B+ (and below)	100%	150%	Deduction from capital
Unrated	100%	100%	Deduction from capital

The Table indicates that there will be a substantial improvement in the risk weighting of securitised instruments in the higher "A" rating categories. Indeed, the capital required to hold AAA to AA- rated RMBS (20%) will be less than for the underlying mortgages (say 35%). This may encourage ADIs to seek exposure to the residential mortgage market not directly, but synthetically, through RMBS.

It is likely that warehouse facilities will be structured to take advantage of the substantial capital benefits arising from a rating in the higher categories. We may see these being documented in the form of securities and structured into classes, so as to internally credit enhance the transaction to obtain a higher rating for the most senior classes. The securities will need to be publicly rated in order to enjoy the concessional risk-weights referred to above.

The ASF has sought for many years for a concessional risk weighting for MBS to reflect the risk weighting of the underlying assets. The ASF's last submission to APRA on this subject was in 2002. At the time APRA suggested that the issue could be best dealt with within the Basel II capital process. It looks likely that substantial capital concessions will be available, of at least 20% or 50% (depending on the rating).

In a typical two Class A/Class B transaction, which is pool insured, the following risk weights usually apply:

Tranche	Rating	Current Risk Weighting	Likely Basel II Risk Weighting
A	AAA	100%	20%
B	AA	100%	20%

It is still too early to be entirely confident that the goal has finally been achieved. When rejecting the ASF's 2002 submission, APRA suggested that there may be policy arguments in favour of tightening rather than loosening the rules related to home lending. As we have just seen with the risk weighting of residential mortgages, APRA does not see itself bound necessarily by the Basel II Framework and it may regard a reduction in the risk weighting of MBS from 100% to 20 or 50% as too great to accept.

Standby Commitments

Standby commitment in the context of securitisation will be dealt with under APS120.

The Basel II Framework indicates the following for securitisation:

- The risk weighting of undrawn commitments is to be measured by multiplying a credit conversion factor (CCF) by the appropriate risk weighting.
- Generally, the CCF will be 100% except for the following:

- Complying undrawn servicer cash advances or facilities: 0%
- APRA has confirmed that it will accept this in its list of IRB discretions that it will exercise.
- Eligible liquidity facilities:
 - With a maturity of 1 year or less: 20%
 - With a maturity greater than 1 year: 50%
 - If rated: 100%
- Generally, unrated securitisation exposures must be deducted from capital, except:
 - The most senior exposures in a securitisation (which then look through to the risk weighting of the underlying assets).
 - Eligible liquidity facilities:
 - If rated, then the capital related to their rating will apply.
 - Otherwise, the capital weighting of the underlying structure will apply (on a look through basis).
 - Undrawn servicer cash advances or facilities with a CCF of 0%.
- Also, the new rules under APS112 permit a 0% risk weighting where the terms of the undrawn commitment effectively provide for automatic cancellation due to a deterioration in the borrower's credit worthiness. This is not replicated in the Basel II Framework for securitisation and it is unclear whether this will be applied in APS 120.

The allocation of capital to undrawn commitments is likely to further accelerate the move to extendable CP in the ABCP market.

APS 114 Capital Adequacy: Standardised Approach to Operational Risk

The need to hold capital against an ADI's operational risks is new and stems from the Basel II Framework. Importantly when the new Prudential Standard comes into force capital will have to be held against the operational risks involved with securitisation. Accordingly, ADIs involved in securitisation should expect from 2008 to hold additional capital in circumstances where at present this is not required.

Operational risk is defined by the Prudential Standard as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The definition includes legal risk (which in turn includes but is not limited to, exposures to fines, penalties or punitive damages resulting from supervisory actions as well as private settlements). Operational risk excludes strategic and reputational risk.

In addition to holding capital against operational risk, an ADI will be required to have in place a comprehensive risk management framework for operational risk. The requirements for managing operational risk by an ADI will be set out in a new Prudential Standard (as yet unpublished).

In the Prudential Standard, an ADI's activities are divided into two areas of business:

- (a) retail/commercial banking; and
- (b) all other activity.

The operational risk capital requirement for the retail/commercial banking area is determined using a proportion of an ADI's total gross outstanding loans and advances as an indicator of that area's operational risk exposure.

An ADI's total gross outstanding loans and advances is defined as the total on-balance sheet amounts of the following credit portfolios as disclosed in the ADI's regulatory reporting return:

- (a) loans to households;

- (b) loans to community service organisations and non-profit institutions;
- (c) loans to non-financial corporations;
- (d) loans to general government; and
- (e) loans to financial corporations.

The gross book value of securities held in the ADI's banking book, subject to some exceptions, must also be included in the ADI's total gross outstanding loans and advances. This does not include the book value of securities arising from an ADI's involvement in corporate finance related activities, such as underwriting and any holding of equity or debt arising from that underwriting, and the origination of facilitation and management activities associated with securitisations.

The operational risk capital requirement for the retail/commercial banking area of business is calculated by:

- (a) taking the last 6 consecutive half-yearly observations of total gross outstanding loans and advances;
- (b) multiplying a proportion, being 3.5%, of total gross outstanding loans and advances at each observation point, by a factor of 15% to produce a result in respect of each observation; and
- (c) determining an average result for the 6 observations.

The operational risk capital requirement for the all other activity area is determined using a proportion of an ADI's net income as an indicator of that area's operational risk. This includes an ADI's net income (including net interest income) from its involvement in securitisation (including servicing).

The operational risk capital requirement for the all other activity area of business is calculated by:

- (a) taking the last 6 consecutive half yearly observations of net income earned over a six month period;
- (b) multiplying the net income at each observation point by 18%; and
- (c) averaging the result over the 3 years period.

When an ADI engages in a securitisation of (say) its residential mortgages, those mortgages will move out of the calculation of the capital to be held for the operational risk of retail/commercial banking and will be taken into account for the calculation of the net income for the all other activity area. Consequently, when an ADI engages in securitisation, there may be a release of the capital it holds for the operational risks of retail/commercial banking as compared to the all other activity area.

Conclusion

Basel II is likely to have a profound effect on the securitisation market. On one hand, it will reduce the capital incentives to securitise; but at the same time it will encourage ADIs to have RMBS in their portfolios, but will also increase the cost of ADIs providing facilities and commitments to securitisation structures and participating in securitisation. It is too early to predict the net outcome, but one thing is certain: It will be the single most important influence in shaping the direction and structure of the market over the next 5 years.

If you'd like further information about this topic, contact:



Brian Salter
 Partner
 T +61 2 9353 4174
 F +61 2 8220 6700
 bsalter@claytonutz.com

Disclaimer: This paper is intended to provide commentary and general information. It should not be relied upon as legal advice. Formal legal advice should be sought in particular transactions or on matters of interest.

@Clayton Utz. All rights reserved. No part of this work may be reproduced in any material form or communicated by any means without permission of the copyright owner.