How to Revive the European Securitisation Market:
A Proposal for a European SSFA

Executive Summary

Policy-makers in Europe have identified the revival of the securitisation market as an important step in the effort to restore growth in the European economy. Securitisation can supply the funding required for banks to lend to SMEs and consumers, bolstering key areas of real economic activity.

The rules on bank capital for securitisation investments are impeding revival in the European securitisation market. The current framework bases capital charges on agency ratings. The criteria that agencies employ in assigning ratings have become significantly more conservative since the crisis. The capital premium, the ratio between (i) the capital a bank must maintain if it holds all the tranches of a securitisation and (ii) the capital required if it holds all the underlying pool assets, has become, in much of the securitisation market, very large.

The Basel Ratings and Securitisation Workstream (RSW) has been working on a new set of capital rules for securitisations. These include an External Ratings Based Approach (ERBA) and two formula-based approaches, the Internal Ratings Based Approach (IRBA) and the Standardised Approach (SA). Both of the latter employ a formula called the Simplified Supervisory Formula Approach (SSFA). The ERBA in the RSW's proposals further increases the conservatism of bank capital for securitisations compared to the current framework's Ratings Based Approach (RBA).

The European Central Bank and the Bank of England recently published papers suggesting that the conservatism of current bank capital rules for securitisations may be excessive. These papers point to the generally favourable performance of European securitisations during the crisis. They suggest that a category of High Quality Securitisations (HQS) might be identified that could be afforded differentiated regulatory treatment.

There has been extensive debate within the industry and the regulatory communities on how such a category of HQS might be defined. An important related question which has received much less attention, however, is: how might HQS status be reflected in regulatory rules and, in particular, in capital regulations?

In their new paper "How to Revive the European Securitisation Market: A Proposal for a European SSFA", Duponcheele, Linden and Perraudin directly answer this question. The authors propose that the European authorities immediately adopt an adjusted version of the SSFA, the formula lying behind the Basel RSW's SA and IRBA capital formulae.

The adjustments that Duponcheele et al. propose to the SSFA formula are relatively small. Early adoption of the SSFA by the European Parliament as an amendment to current regulations would not preclude consistency with the framework being developed by the RSW.

If the European authorities were to take the approach of adopting the SSFA early for HQS, they would follow in the footsteps of US regulators, who in October 2013 issued their "Final" Basel III rule on securitisation (involving use of the SSFA) before the Basel approach had been determined. The Basel/IOSCO Task Force on Securitisation Markets, currently considering how to modify the capital rules to allow for an HQS category, might then build on this European approach to the issue.

To provide perspective on the current and proposed approaches to calculating bank capital, Duponcheele, Linden and Perraudin provide a comprehensive analysis of how these approaches perform using a dataset of 1,771 actual European securitisation tranches. Their study reveals a set of important facts about the current rules and the rules proposed by the RSW. These facts are:

- In the Basel capital rules currently in force, the ratings-based approaches are substantially more conservative than the formula-based approach (the Supervisory Formula Approach (SFA)). For examples, in the dataset, (on a par-weighted-value basis) RBA capital is around ten times higher than SFA capital for "Most Senior" tranches of RMBS transactions and three times higher for SME-backed tranches.
- Such inconsistency is particularly troublesome because the US Dodd-Frank act precludes the use of ratings based capital formulae by US banks whereas regulatory practices in Europe mean that, de facto, in the great majority of cases, European banks must use the ratings based approaches. As a result, there is a very uneven playing field between European and US banks.
- In the current RSW proposals (contained in the December 2013 document BCBS 269), inconsistency remains between the ratings-based approach (in that case the ERBA) and the formula-based approaches (the IRBA and SA). On a par-value-weighted basis, the average risk weights for SME-backed loans are 15% and 83% under the IRBA and ERBA respectively. For RMBS, the comparable average risk weights are 16% and 72%. For Other Retail (including auto-loans), the average risk weights are 15% under the IRBA and 33% under the ERBA.
- The RSW proposals include a floor for capital of 15%. Intended to protect against model risk and other types of risk that are difficult to foresee, the floor is pitched at a level that unfortunately removes almost all risk sensitivity for the better quality segment of the market. Bank investments in other banks' securitisations are concentrated in the "Most Senior" tranches. Among these, under the IRBA, capital is determined by the floor for 96% of 550 such tranches in the dataset.
- The authors also present comparisons of risk weights calculated using the various approaches with those implied by a rigorous and formal risk model. This model, labelled the Conservative Monotone Approach (CMA), is based on a series of papers produced by a group of industry securitisation risk experts that includes the authors.

Duponcheele, Linden and Perraudin also explain four technical errors in the current RSW proposals. They are (i) the failure to adjust attachment and detachment points for under- or over-collateralisation, (ii) the inclusion of delinquencies in capital allocated to senior tranches in the SA version of the SSFA, (iii) the failure to adjust the capital threshold in the IRBA for delinquencies (this introduces an inconsistency with the SA), and (iv) the use of an inappropriate definition for maturity in the IRBA and the ERBA which results in discrimination against European countries with long legal processes.

These technical errors introduce undesirable noise in the capital calculations by assigning some securitisation tranches quite inappropriate risk weights. When these errors are eliminated, the resulting risk weights are noticeably closer to those implied by the benchmark CMA model.

The proposed European SSFA is designed by (i) developing an SSFA-based model similar to the current RSW proposals, (ii) correcting the four technical errors described above, and (iii) introducing simple adjustments that yield capital levels for the benchmark 1,771 tranches that are close to those implied by the CMA.

Early adoption of this European SSFA would remove the biggest obstacle to revival of the European securitisation market: overly conservative capital requirements highly dependent on ratings agency views of relative risk.