Annex 3

ENHANCEMENTS TO
BASEL II SECURITIZATION FRAMEWORK

I. INTRODUCTION

In July 2009, the Basel Committee on Banking Supervision ("BCBS") formally issued after public consultation the paper entitled *Enhancements to the Basel II framework*, which includes requirements to strengthen the securitization framework through tightening the treatment of securitization exposures (especially resecuritization exposures)[1] in the light of lessons learned from the financial crisis. The BCBS expects banks to comply with the revised requirements by 31 December 2010.

2. This paper describes the key changes to the securitization framework and the amendments that will be made to the Banking (Capital) Rules ("BCR") in order to implement the requirements in Hong Kong.

II. SUMMARY OF ENHANCEMENTS TO SECURITIZATION FRAMEWORK

3. The following are the main changes to the securitization framework:

(a) <u>Resecuritization exposures</u> – Application of higher risk weights to such exposures under the standardized (securitization) approach ("STC(S) approach") and the internal ratings-based (securitization) approach ("IRB(S) approach");

[1] Unless the context indicates otherwise, "securitization exposures" referred to in this paper generally include resecuritization exposures.

(b) Ratings based on self-guarantees – To avoid situations where a bank understates the credit risk capital requirements of a securitization exposure by using a credit rating on the exposure that is based on guarantees or similar support provided by the bank itself for risk-weighting the exposure, the bank is required to treat the exposure as if it is unrated under both the STC(S) approach and the ratings-based method (“RBM”) of the IRB(S) approach;

(c) Operational requirements for credit analysis – Banks will be required to meet specific operational criteria in order to use the risk weights specified in the Basel II securitization framework. These criteria are intended to ensure that banks perform their own due diligence and do not simply rely on credit ratings issued by external rating agencies. Failure to meet these criteria for a given securitization exposure would result in its deduction from the capital base;

(d) Liquidity facilities – The capital treatment for liquidity facilities under the STC(S) approach and the IRB(S) approach is tightened, and clarification is made concerning the circumstances in which liquidity facilities may be treated as senior securitization positions under the IRB(S) approach. Moreover, the favourable capital treatment afforded general market disruption lines under both approaches is eliminated.

4. The HKMA will implement the above changes by amending the relevant sections of the BCR.

III. PROPOSED AMENDMENTS TO BANKING (CAPITAL) RULES

(A) Resecuritization exposures

5. The revised risk-weighting framework will require AIs to identify resecuritization exposures within their securitization exposures. A resecuritization exposure is a securitization exposure in which the risk associated with a pool of underlying exposures is tranched and at least one of the underlying exposures is a securitization exposure. In addition, an exposure to one or more resecuritization exposures is a resecuritization exposure. The latter includes situations where the performance of an instrument is linked to one or more resecuritization exposures (e.g. a credit derivative contract providing credit protection to a CDO[2] tranche). The interpretation sections of the BCR[2] (i.e. section 2 and section 227) will be amended to incorporate such distinction.

6. As shown in the following tables, resecuritization exposures will be subject to higher risk-weights compared to other securitization exposures under both the RBM of the IRB(S) approach and the STC(S) approach.

[2] All section references included in this paper are those of the BCR.

Table 1: Risk-weights for securitization exposures in RBM of IRB(S) approach

<table>
<tr><th colspan="2" rowspan="2">Credit Quality Grade (“CQG”)[3] / External credit assessment (for illustrative purposes)[4]</th><th colspan="5">Securitization exposures</th></tr>
<tr><th colspan="2">Resecuritization exposures</th><th colspan="3">Other securitization exposures</th></tr>
<tr><th>Long-Term</th><th>Short-Term</th><th>Senior</th><th>Non-senior</th><th>Senior[5], granular[6]</th><th>Non-senior, granular</th><th>Non-granular</th></tr>
<tr><td>CQG 1 (AAA to AA+)</td><td>CQG 1 (A-1+ to A-1)</td><td>20%</td><td>30%</td><td>7%</td><td>12%</td><td>20%</td></tr>
<tr><td>CQG 2 (AA to AA-)</td><td></td><td>25%</td><td>40%</td><td>8%</td><td>15%</td><td>25%</td></tr>
<tr><td>CQG 3 (A+)</td><td></td><td>35%</td><td>50%</td><td>10%</td><td>18%</td><td rowspan="3">35%</td></tr>
<tr><td>CQG 4 (A)</td><td>CQG 2 (A-2)</td><td>40%</td><td>65%</td><td>12%</td><td>20%</td></tr>
<tr><td>CQG 5 (A-)</td><td></td><td>60%</td><td>100%</td><td>20%</td><td>35%</td></tr>
<tr><td>CQG 6 (BBB+)</td><td></td><td>100%</td><td>150%</td><td>35%</td><td colspan="2">50%</td></tr>
<tr><td>CQG 7 (BBB)</td><td>CQG 3 (A-3)</td><td>150%</td><td>225%</td><td>60%</td><td colspan="2">75%</td></tr>
<tr><td>CQG 8 (BBB-)</td><td></td><td>200%</td><td>350%</td><td colspan="3">100%</td></tr>
<tr><td>CQG 9 (BB+)</td><td></td><td>300%</td><td>500%</td><td colspan="3">250%</td></tr>
<tr><td>CQG 10 (BB)</td><td></td><td>500%</td><td>650%</td><td colspan="3">425%</td></tr>
<tr><td>CQG 11 (BB-)</td><td></td><td>750%</td><td>850%</td><td colspan="3">650%</td></tr>
<tr><td>CQG 12 (Below BB-)</td><td>CQG 4 (Below A-3)</td><td colspan="5">Deduction</td></tr>
</table>

3 See Schedule 14 to the BCR.

4 The rating notations are those of Standard & Poor’s.

5 Under section 262(2), if an AI holds a securitization position in a given tranche of a securitization transaction and the tranche is effectively backed or secured by a first legal claim on the entire amount outstanding in respect of the underlying exposures in the transaction, the AI should treat the securitization position as a senior position.

6 Under section 262(5)(a)(i), a securitization exposure is “granular” if the effective number of underlying exposures is not less than 6.

7. As shown in Table 1 above for risk-weighting securitization exposures using the RBM under the IRB(S) approach, two additional rating scales will be incorporated to cater for the higher levels of risk associated with resecuritization exposures that are senior and those that are non-senior in nature. A senior resecuritization exposure is an exposure (a) which qualifies as a senior position under section 262(2) and (b) where none of the underlying exposures are themselves resecuritization exposures. Any resecuritization exposure where the underlying exposures include resecuritization exposures is categorised as a non-senior resecuritization exposure. Section 262, together with Table 26 and Table 27 that come under the section, will be amended to reflect the different treatment for resecuritization exposures.

8. In line with the RBM, the floor risk-weight for the supervisory formula method ("SFM") under the IRB(S) approach will also be raised from 7% to 20% for resecuritization exposures. Section 270(4)(a) will be amended accordingly.

Table 2: Risk-weights for securitization exposures in STC(S) approach

Credit quality grade (“CQG”)[7] / External credit assessment (for illustrative purposes)[8]		Long-term	CQG 1 (AAA to AA-)	CQG 2 (A+ to A-)	CQG 3 (BBB+ to BBB-)	CQG 4 (BB+ to BB-)	CQG 5 (Below BB-)
		Short-term	CQG 1 (A-1+ to A-1)	CQG 2 (A-2)	CQG 3 (A-3)		CQG 4 (Below A-3)
Securitization exposures	Resecuritization exposures		40%	100%	225%	650%	Deduction
	Other securitization exposures		20%	50%	100%	350%	Deduction

9. Similar to the IRB(S) approach, as shown in Table 2 above for risk-weighting securitization exposures under the STC(S) approach, a more stringent risk-weighting scale will be incorporated to cater for the higher levels of risk associated with resecuritization exposures. Section 237, together with Table 24 and Table 25 that come under the section, will be amended to reflect the different treatment for resecuritization exposures.

(B) Ratings based on self-guarantees

10. An AI will not be permitted to use any external credit assessment of a securitization exposure for risk-weighting purposes where the assessment is at least partly based on unfunded support (for instance, in the form of a liquidity facility or credit enhancement) provided by the AI to the exposure. In such cases, the AI should treat the exposure as unrated.

11. An AI will be permitted to recognize any overlap between the unfunded support it provides to a securitization structure and any securitization position it holds in the structure that is covered by the unfunded support. For instance, an AI providing a liquidity facility supporting 90% of the commercial paper issued under an asset-backed commercial paper (“ABCP”) programme and purchasing 20% of the outstanding ABCP can recognize an overlap of 10%

7 See Schedule 11 to the BCR.
8 The rating notations are those of Standard & Poor’s.

(i.e., 90% liquidity facility + 20% ABCP held – 100% ABCP issued = 10%) in calculating the capital requirements of the facility and the ABCP held. If the liquidity facility and the ABCP fall within the situation described in paragraph 10 above, the 20% ABCP held should be treated as unrated whereas the liquidity facility should be subject to capital requirement as usual. The overlapping portion should be attributed to the exposure which will result in a higher capital requirement. If an AI provided a liquidity facility that covered 50% of the outstanding ABCP and purchased 20% of the ABCP, the two exposures would be treated as if there were no overlap.

12. The treatment described in paragraph 10 will also apply to an AI's securitization exposures in the trading book. Moreover, an AI will be allowed to apply the treatment described in paragraph 11 for recognizing the overlap of securitization exposures even if one of the exposures (e.g. the ABCP held in the above example) is held in the trading book, provided that the AI is able to calculate and compare the capital requirements for the relevant exposures.

13. Section 241 for the STC(S) approach and section 253 for the IRB(S) approach on the treatment of overlapping facilities will be expanded to incorporate the above requirements. Part 8 (re: calculation of market risk) will also be amended to include the new requirements applicable to securitization exposures in the trading book.

(C) Operational requirements for credit analysis

14. In order for an AI to use the STC(S) approach or the IRB(S) approach for risk-weighting securitization exposures, the AI will be required to satisfy certain criteria as evidence that it has performed a suitable level of due diligence in understanding and monitoring the risks associated with the exposures. The AI will have to deduct from its capital base those securitization exposures for which the criteria have not been satisfied. The criteria include:

(a) a comprehensive understanding on an ongoing basis of the risk characteristics of the AI's individual securitization exposures, whether on-balance sheet or off-balance sheet, as well as the risk characteristics of the pools of underlying exposures;

(b) an ability to access on an on-going basis timely performance information on the pools of underlying exposures, which may include, as appropriate, exposure type, percentage of loans 30, 60 and 90 days past due, default rates, prepayment rates, loans in foreclosure, property type, occupancy, average credit score or other measures of creditworthiness, average loan-to-value ratio, and industry and geographic diversification. For resecuritization exposures, the AI should have information not only on the underlying securitization tranches (such as the issuer name and credit quality), but also on the characteristics and performance of the pools underlying the securitization tranches; and

(c) a thorough understanding of all structural features of a securitization transaction that would materially impact the performance of the AI's exposures to the transaction, such as contractual waterfall and waterfall-related triggers, credit enhancements, liquidity enhancements, market value triggers, and deal-specific definitions of default.

15. The above criteria apply similarly to securitization exposures in the trading book. In other words, an AI will have to deduct from its capital base any such exposure for which the specified criteria cannot be satisfied.

16. The above criteria will be incorporated under Division 2 of Part 7 which deals with the general requirements applicable to the use of the STC(S) approach and the IRB(S) approach. Relevant sections of Part 8 will also be updated.

(D) Liquidity facilities

Credit conversion factor ("CCF")

17. Under the STC(S) approach, the CCF applicable to unrated eligible liquidity facilities will be made uniform at 50%, regardless of the maturity of the facilities. Under the current framework, such facilities under one year receive a 20% CCF.

18. Under the IRB(S) approach, where it is not practicable for an AI using the SFM to calculate the K_{IRB}, the AI may, with the prior consent of the Monetary Authority, use another method to calculate the risk-weighted amount of unrated eligible liquidity facilities. The CCF applicable to such facilities under that method will be made uniform at 100%, regardless of the maturity of the facilities. Under the current framework, such facilities under one year receive a 50% CCF.

19. Section 240(2)(b) for the STC(S) approach and section 277(3)(b) for the IRB(S) approach will be amended to reflect the above changes.

Clarification on liquidity facilities to be treated as senior position under IRB(S) approach

20. Clarification will be made in section 262 to distinguish between liquidity facilities that should be treated as senior and those that should not under the RBM. In particular, a liquidity facility supporting an ABCP programme will be regarded as the most senior position within the programme only if it is sized to cover all of the outstanding commercial paper and other senior debt supported by the pool of underlying exposures in the programme, so that no cash flows from the underlying exposures could be transferred to other creditors until any liquidity draws were repaid in full.

Market disruption lines

21. The existing preferential CCF for eligible liquidity facilities that are "only available in the event of general market disruption" (i.e. 0% for the STC(S) approach and 20% for the SFM under the IRB(S) approach) will be eliminated. The corresponding section 240(3) for the STC(S) approach and section 277(1)(c) and 277(3)(b)(iii) for the IRB(S) approach will be removed accordingly.

(E) Implementation date

22. The HKMA plans to put into effect the above amendments to the BCR from 1 January 2011.