Examining Key Regulations through the Global Lens: *Regulatory Capital for Banks and Insurers*[*]

KEVIN P. HAWKEN, CHRISTOPHE CADIOU, KATIE MCCAW, AND OLIVIER TRECCO

KEVIN P. HAWKEN
is a partner at
Mayer Brown International LLP
in London, U.K.
khawken@mayerbrown.com

CHRISTOPHE CADIOU
is a partner at PWC
in Atlanta, GA.
christophe.cadiou@us.pwc.com

KATIE MCCAW
is a professional support lawyer at
Baker & McKenzie LLP
in London, U.K.
katie.mccaw@bakermckenzie.com

OLIVIER TRECCO
is an insurance regulation expert at
Natixis in London, U.K.
olivier.trecco@uk.natixis.com

Panel Members

KEVIN P. HAWKEN
Moderator

CHRISTOPHE CADIOU

KATIE MCCAW

OLIVIER TRECCO

The panel, "Examining Key Regulations through the Global Lens: Regulatory Capital for Banks and Insurers," was held on June 11, 2014, at the Global ABS 2014 conference in Barcelona, Spain.

Regulatory capital requirements have always been a key driver for securitization transactions. Securitization's effects on capital requirements are important both for bank originators, seeking to free up capital for further lending and other transactions, and for banks, insurance companies, and other institutions investing in securitizations.

Recent and proposed changes to capital rules for banks and insurance companies point to increasing the amount of capital required for securitization exposures to levels that are much higher than the capital required for those transactions under existing rules, that are required for other kinds of financial instruments with comparable credit quality, or that would have been required to cover losses on most types of securitization transactions even during the financial crisis. Despite many statements by policy makers and regulators supporting redevelopment of a healthy securitization market, the regulatory trend in capital requirements is likely to hamper re-growth of the market.

This panel focused on two pending regulatory proposals: the Basel Committee on Banking Supervision's (BCBS) second consultation document on revisions to the Basel securitization framework (BCBS 269),[1] published in December 2013 with a comment period that ended on March 21, 2014, and the European Insurance and Occupational Pension Authority's (EIOPA) Technical Report on Standard Formula Design and Calibration for Certain Long-Term Investments (EIOPA/13/513),[2] also published in December 2013 and being considered by the European Commission (EC). The Basel proposal relates to the international standards for capital treatment of securitizations by banks acting as originators or sponsors of or

[*] This article first appeared on *Journal of Structured Finance*

investors in securitization, while the EIOPA proposals relate to capital requirements under the Solvency II Directive for European insurance and reinsurance companies as investors.

The panel members described where each of these proposals stands in its rulemaking process and when they might be finalized and implemented. They also discussed some of the issues that have been identified in comments on the Basel proposal and described the overall structure and method of the Solvency II framework and securitization's place within it. Finally, they touched on some emerging trends, including the greater importance of stress testing for major banks and moves to provide less onerous capital treatment for securitizations meeting defined criteria (as in the EIOPA paper) or to calibrate inputs separately for different regulatory or market-standard asset classes (as in comments on the Basel proposal).

Basel Securitization Framework Timeline

Addressing the timeframe for the finalization and implementation of the BCBS 269 proposals, Katie McCaw noted that the BCBS committed simply to publishing the final standard "within an appropriate timeframe." With industry feedback and results of the latest Quantitative Impact Study (QIS) currently being factored into the framework, we may expect to see the final rules being issued by the end of 2014 or early 2015. This depends, however, on whether the separate proposals being developed by the European securitization industry for a new definition of (and, potentially, a more beneficial regulatory treatment of) "high quality securitization" will be factored into the final rules. If so, this is likely to necessitate further revisions to the framework, and we may expect to see those contained in a third consultative document, which would further delay the process. Picking up on comments made earlier in the day by conference keynote speaker Yves Mersch, a member of the European Central Bank's executive board, who suggested that it would be unlikely that the BCBS would take forward the "high quality securitization" initiative within BCBS 269, panelists noted that the lack of a global playing field in this regard could have negative consequences, with European and U.S. (and other) regulators potentially taking divergent approaches.

Leaving aside the question of whether "high quality securitization" will be incorporated into the BCBS 269 framework and assuming the framework is published in final form by the end of 2014, member countries would have, perhaps, 12 to 14 months in which to consult upon and agree upon implementing measures. Allowing for a transitional period of (up to) 12 months, banks could be subject to the final framework by the end of 2016. In that case, the time lag between the beginning of the global financial crisis and the implementation of these rules (which are said to form part of the BCBS' broader financial market reforms in direct response to the crisis) will be nearly a decade.

Basel Securitization Revisions—Issues for Banks

Christophe Cadiou discussed some of the other key issues with respect to the BCBS 269 proposals and commented in particular on how these proposals affect the playing field between the U.S. banks and their counterparts outside of the U.S.

On the one hand, some of the BCBS 269 proposals will level the playing field in areas where U.S. banks were subject to more restrictive rules than their competitors. For instance, reducing the risk-weight floor from 20% (current floor in the United States) to 15% will provide capital relief to U.S. banks for good-quality securitization exposures, whereas non-U.S. banks will see an increase in the floor from the current 7%. Another example of a more-level playing field relates to the due diligence requirements. The inability to perform the due diligence requirement is currently penalized with a 1250% risk weight in the United States, versus a 2.5 multiplier on the risk weight of the tranche for non-U.S. banks. The BCBS 269 proposals adopt the U.S. treatment, which will significantly increase the due diligence breach penalty for banks outside of the United States, and level the playing field.

On the other hand, the BCBS 269 proposals will limit the choice of approaches for the U.S. banks. Because external ratings cannot be applied in the United States, banks will be forced to use either the internal ratings-based approach (only available for banks with $250 billion or more in assets in the United States) or the standardized approach. The external ratings-based approach (ERBA), which provides for simplicity of implementation and better risk weights in many cases, cannot be applied in the United States. Likewise, the internal assessment approach will not be allowed for U.S. banks, as it is only applicable in jurisdictions that allow for ERBA; this will likely penalize large banks in the United States that have sizable securitization exposure to asset-backed commercial paper (ABCP) facilities (in the form of credit enhancement and liquidity facilities).

Regulators' focus on testing banks' capital and liquidity requirements during stressed periods is also placing greater strain on balance sheets and capital planning. Christophe commented on the fact that stressed capital has become the primary binding constraint in the United States as a result of the implementation of the Comprehensive Capital Analysis and Review (CCAR). Europe is not far behind with the European Banking Authority (EBA) stress test.

CRD IV/CRR Implementation

Within Europe, the legislative process for implementing BCBS 269 will be via the Capital Requirements Directive IV (CRD IV) and Regulation (CRR). A "CRD V" is not necessary as CRD IV/CRR (which form the key pillar of the European Commission's "Single Rulebook for Banks") use the post-Lisbon Treaty legislative process by which the so-called Level 1 legislation (CDR IV/CRR) is accompanied by Level 2 "Delegated Acts" (Regulatory Technical Standards, or RTS, and Implementing Technical Standards, or ITS) and Level 3 "Guidance," all of which supplement the Level 1 text with additional detail that can be easily and quickly amended over time. In particular, the use of a European Commission regulation as the key legislative vehicle for the bulk of the legislative provisions means that amendments can be made (also by way of regulations), with no need to resort to the lengthy negotiation and implementation timeframes associated with amending Directives. In addition, EC regulations have direct applicability in European Union (EU) member states, eliminating the need to develop an additional layer of national legislation to implement them. The result is "maximum harmonization," with member states prevented from "gold-plating" the legislation with additional or more onerous requirements.

McCaw noted that there are more than 100 areas in which RTS and ITS are required to be developed under CRD IV/CRR (thankfully, not all are securitization related) and drew attention to the key areas in which these measures are required in the securitization space, noting the progress made to date on each: the detailed RTS on risk retention and accompanying ITS on penalties for infringement (which have now been published in final form in the *Official Journal of the European Union*); RTS regarding the "mapping" of external credit assessment institutions to CRD IV's credit quality steps (which were set out in draft form in February 2014 and were due to be delivered to the EC in July 2014); and a set of guidelines on "significant risk transfer" (issued in final form by the European Banking Authority in July 2014 and which may become an RTS or ITS in due course).

As the rulemaking process under the CRD IV/CRR legislative framework will clearly continue to play out for some time, McCaw highlighted some other outstanding issues for securitization transactions that are having an impact on issuance levels and investor participation in the market. Among these issues is the inclusion of residential mortgage-backed securities (RMBS) as “high-quality liquid assets” (HQLAs) for the purposes of the BCBS/Basel III Liquidity Coverage Ratio—in particular, whether the final iteration of these rules (publication of which the European Commission has recently delayed until September 2014) will allow for a wider range of RMBS to meet the definition of HQLAs and whether eligibility will be expanded to include other classes of asset-backed securities (ABS) beyond the limited set of RMBS that are eligible under the most recent draft of the rules. The treatment of securitization in this rule was compared with the (almost) unrestricted amount of covered bonds eligible as HQLAs (and other comparisons between ABS and covered bonds, for example, in terms of risk-weighting treatment, can be drawn). Other key issues include whether growing support from European regulators for “high-quality securitization” will (as mentioned earlier) be factored into the capital adequacy framework, such that high-quality deals benefit from favorable regulatory and risk-weighting treatment, not to mention positive investor sentiment and consequent market upturn.

Differing terminology is being used to describe the concept of high-quality securitization (HQS). The Solvency II proposals distinguish between Type A and Type B securitizations. A recent discussion paper by the Bank of England and European Central Bank’s suggests the development of a definition of “qualifying securitizations.”[3] Others, including industry associations, appear to favor “high-quality securitization.” Whatever the terminology ultimately used (if any), the crucial issue will be to develop a sensible, inclusive definition of “high quality” (taking account of any possible unintended consequences resulting from what does *not* fall within the definition), and its application on the broadest possible scale, both in terms of jurisdictional and sectoral application.

Solvency II Developments

McCaw also noted that the Solvency II legislation is on a slightly different implementation timeframe from BCBS 269, with the Solvency II Directive scheduled to be transposed in EU Member States from March 31, 2015, and take effect on January 1, 2016.

Olivier Trecco gave a brief overview of the Solvency II regulatory architecture, noting first that because of significant differences in calculation methods (under Solvency II, aggregation of risk modules is non-linear and allows for diversification and loss absorption mechanisms), capital charges for securitizations under the banking and insurance regulations cannot be directly compared one to one. Risk factors in the Solvency II calibration represent gross capital charges, while only net capital charges, which allow for diversification and loss absorption and therefore depend on the unique risk profile of each insurer, could really compare with banking risk-weighted assets.

For its part, EIOPA has pioneered a granular approach to securitizations by distinguishing between Type A and Type B securitizations, the former being treated more favorably in the latest public version of the Technical Specifications: Type A—AAA rated notes would attract 2.1% x duration gross capital charge, down to BBB rated notes which would attract 8.5% x duration; in comparison, Type B—AAA rated notes would attract 12.5% x duration. It is unfortunate, however, that even with this new calibration, doing a portfolio trade (no tranching, meaning look-through principle applies) is currently treated more favorably than buying a tranched deal (even though the latter provides more protection) on the same collateral (mortgages, corporate loans). Panelists remarked, however, that those calibration figures might still change, as the European Commission is expected to produce its draft Delegated Acts project in September 2014.

Trecco further detailed the key criteria that would classify a note into Type A. For those items that will be issued before Solvency II enters into force, only the following should be relevant:

- minimum rating BBB
- the tranche is not subordinated to other tranches
- true sale
- eligible underlying assets; residential mortgages; loans to small- and medium-sized enterprises (SMEs); leased property; consumer loans; credit card receivables.

Securitizations issued on or after January 1, 2016, will need to respect an increased number of criteria to be included in Type A (in particular, listing requirements).

Principles for Qualifying Securitization

More generally, the point was made that in order to encourage healthy development of the securitization markets in support of real-economy financing, regulatory treatment should not be linked to the underlying asset category: risks of cliff effects in the delimitation of eligible assets, as exemplified by the restriction in Solvency II of underlying assets to SME loans, when large caps also need refinancing and risk reverting to shadow finance. Rather, in line with a focus on transparency, the credit quality of securitized assets, the effective contribution to real-economy financing—as well as to the structural enhancement provided to the investor through the securitization—should be the key criteria. Similarly, the regulatory treatment should not unduly attract significantly more capital requirements for senior tranches of securitization compared with direct investments in the same underlying assets, even though the former provides more loss protection. Efforts to put in place an HQS label have to be focused on the need for transparency and, therefore, accessible, harmonized, and comprehensive data and historical records, and avoid a system that ultimately would act to discharge the investor from its risk analysis and due diligence responsibilities.

ENDNOTES

[1] See http://www.bis.org/publ/bcbs269.pdf
[2] See https://eiopa.europa.eu/fileadmin/tx_dam/files/publications/reports/EIOPA_Technical_Report_on_Standard_Formula_Design_and_Calibration_for_Certain_Long-Term_Investments—2_.pdf.
[3] Bank of England and European Central Bank, "The Case for a Better Functioning Securitisation Market in the European Union," discussion paper, May 29, 2014. Available at http://www.bankofengland.co.uk/publications/Documents/news/2014/paper300514.pdf.