

# Article



## Regulatory risk weight cut down by BIS for STC securitisations

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### Background

The Bank of International Settlement (BIS), which is responsible for laying down capital adequacy standards for the banks across the globe, made revisions in their Securitisation Framework<sup>1</sup>. The genesis of the revised framework lies in a consultation paper on *Capital treatment for “simple, transparent and comparable” securitisations* issued by the BIS on November, 2015<sup>2</sup>.

The Consultation Paper was prepared in order to give effect to the inclusion of Simplicity Transparency Comparable (STC) criteria, which was developed jointly by the BIS and International Organisation of Securities Commission (IOSCO), into the Securitisation Framework in July, 2015<sup>3</sup>. The main intent of the incorporating the STC criteria was because, otherwise, the Framework was not adequately capacitated to address the qualitative elements of structures, thus, helping to mitigate uncertainty related to asset risk, structural risk, governance, and operational risk.

Here in this write up, we intend to cover the changes now made in the Securitisation Framework with respect to the change in the capital treatment for STC securitisations. But before that, let us understand the criteria that needs to be fulfilled in order to qualify to be an STC compliant structure.

### STC criteria

Before delving into the criteria, let us first understand what each of Simple, Transparent and Comparable stands for. BIS discusses about STC in the following manner:

|                     |   |
|---------------------|---|
| <b>Simplicity</b>   | There should be homogeneity of underlying assets with simple characteristics, the transaction structure should not be overly complex.   |
| <b>Transparency</b> | Investors should be sufficiently informed about the underlying assets, the structure of the transaction and the parties involved in the transaction, thereby promoting a more comprehensive and thorough understanding of the risks involved. |
| <b>Comparable</b>   | Securitization products within an asset class should be such that they assist comparison within an asset class.   |

Having discussed the meaning of STC, let us now discuss the criteria laid down under the Framework. The Framework lays down 14 criteria which can be, broadly, classified under three risk types – a) Asset Risk, b) Structural Risk, and c) Fiduciary and Servicer Risk, each of which have been discussed in a tabular form below.

<sup>1</sup> <http://www.bis.org/bcbs/publ/d374.pdf>

<sup>2</sup> <http://www.bis.org/bcbs/publ/d343.pdf>

<sup>3</sup> <http://www.bis.org/bcbs/publ/d332.pdf>



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| <b>Section</b>       | <b>Criteria Summary</b>        | <b>Criteria Brief</b>  | <b>Purpose</b> |
|----------------------|--------------------------------|--|----------------|
| <b>1. Asset Risk</b> | A. Nature of the assets        | <p>i. The assets underlying the securitisation should be receivables that are homogeneous.</p> <p>ii. In assessing homogeneity, asset type, jurisdiction, legal system and currency should be considered.</p>  | S, T, C        |
|                      | B. Asset performance history   | Information with respect to asset performance history, which would allow the investor to conduct appropriate due diligence and a more accurate calculation of expected loss in different stress scenarios, verifiable loss performance data, such as delinquency and default data, should be available for credit claims and receivables with substantially similar risk characteristics to those being securitised, for a time period long enough to permit meaningful evaluation by investors, should be made available to them.   | T, C           |
|                      | C. Payment status              | Only performing credit claims should be securitised.   | S, T, C        |
|                      | D. Consistency of underwriting | <p>i. To ensure that the quality of the securitised credit claims and receivables is not affected by changes in underwriting standards, the originator should demonstrate to investors that any credit claims or receivables being transferred to the securitisation have been originated in the ordinary course of the originator's business to materially non-deteriorating underwriting standards.</p> <p>ii. Where the underwriting standards change, the originators should disclose the timing and purpose of such changes.</p> <p>iii. Underwriting standards should not be less stringent than those applied to credit claims and receivables retained on the balance sheet.</p> | S, C           |



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|---------------------------|---------------------------------|---|---------|
|                           | E. Asset selection and transfer | <ul style="list-style-type: none"> <li>i. Credit claims or receivables transferred to a securitisation should satisfy clearly defined eligibility criteria;</li> <li>ii. There should be true sale of receivables;</li> <li>iii. In jurisdictions preventing true sale, existence of material obstacles preventing true sale and the method of recourse to ultimate obligors must be demonstrated at the time of issuance;</li> <li>iv. The originators should provide representations and warranties that the credit claims or receivables being transferred to the securitisation are not subject to any condition or encumbrance that can be foreseen to adversely affect enforceability in respect of collections due.</li> </ul> | S, T, C |
|                           | F. Initial and ongoing data     | <ul style="list-style-type: none"> <li>i. Assist the investors in conducting appropriate due diligence prior to investing in a new offering;</li> <li>ii. Assist the investor in conducting appropriate monitoring of their investments' performance so that the investors that wish to purchase the securitised instrument in the secondary market can carry out a proper due diligence;</li> <li>iii. Providing a level of assurance that the reporting of the underlying credit claims or receivables is accurate and that the underlying credit claims or receivables meet the eligibility requirement.</li> </ul>  | S, T, C |
| <b>2. Structural Risk</b> | G. Redemption cashflow          | <ul style="list-style-type: none"> <li>i. To help ensure that the underlying credit claims or receivables do not need to be refinanced over a short period of time, there should not be a reliance on the sale or refinancing of the underlying credit claims or receivables in order to repay the liabilities, unless the underlying pool of credit claims or receivables is sufficiently granular and has sufficiently distributed repayment profiles;</li> <li>ii. Rights to receive income from the assets specified to support</li> </ul>  | S       |



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|  |  | redemption payments should be considered as eligible credit claims or receivables in this regard.  |         |
|  | H. Currency and interest rate asset and liability mismatches | In case of payment risk associated with interest rate and currency profiles of the assets and liabilities, interest rate risk and the payment risk shall have to be mitigated at all times. Where a hedging transaction is executed to mitigate the risk, the same should be properly documented.  | S, C    |
|  | I. Payment priorities and observability                      | <p>i. The priorities of payments for all liabilities in all circumstances should be clearly defined at the time of securitisation and appropriate legal comfort regarding their enforceability should be provided;</p> <p>ii. The securitisation should not be structured as a “reverse” cash flow waterfall such that junior liabilities are paid where due and payable senior liabilities have not been paid;</p> <p>iii. The payment profile or priority of payments that might affect a securitisation, all triggers affecting the cash flow waterfall, payment profile or priority of payments of the securitisation should be clearly and fully disclosed and the same should also indicate breach status, the ability for the breach to be reversed and the consequences of the breach. Any triggers breached between payment dates should be disclosed to investors on a timely basis;</p> <p>iv. For revolving structures - provisions for appropriate early amortisation events and/or triggers of termination of the revolving period should be included;</p> <p>v. A liability cash flow model or information on the cash flow provisions must be provided to the investors so as to allow them to carry out modelling of the securitisation cash flow waterfall in an appropriate manner;</p> <p>vi. Situations of debt forgiveness, forbearance, payment holidays,</p> | S, T, C |



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|   |   | restructuring and other asset performance remedies should be clearly disclosed.   |         |
|   | J. Voting and enforcement rights              | <ul style="list-style-type: none"> <li>i. All voting and enforcement rights related to the credit claims or receivables should be transferred to the securitisation;</li> <li>ii. Investors' rights in the securitisation should be clearly defined in all circumstances, including the rights of senior versus junior note holders.</li> </ul>   | S, T, C |
|   | K. Documentation disclosure and legal review  | <ul style="list-style-type: none"> <li>i. The terms, conditions, legal and commercial information prior to investing in a new offering and draft underlying documentation should be made available to investors within a reasonably sufficient period of time prior to pricing such that the investor is provided with full disclosure of the legal and commercial information and comprehensive risk factors needed to make informed investment decision;</li> <li>ii. Final offering documents should be available from the closing date and all final underlying transaction documents shortly thereafter. These should be composed such that readers can readily find, understand and use relevant information;</li> <li>iii. To ensure that all the securitisation's underlying documentation has been subject to appropriate review prior to publication, the terms and documentation of the securitisation should be reviewed by an appropriately experienced third party legal practice, such as a legal counsel already instructed by one of the transaction parties.</li> </ul> | T, C    |
|   | L. Alignment of interests                     | The originator or sponsor of the credit claims or receivables should retain a material net economic exposure and demonstrate a financial incentive in the performance of these assets following their securitisation.   | S, C    |
| <b>3. Fiduciary and Structural Risk</b> | M. Fiduciary and contractual responsibilities | <ul style="list-style-type: none"> <li>i. The servicer have necessary expertise to service the underlying credit claims or receivables, supported by a management team with extensive industry experience;</li> </ul>   | T, C    |



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|  |                              |   |      |
|--|------------------------------|---|------|
|  |                              | <p>ii. The party or parties with fiduciary responsibility should act on a timely basis in the best interests of the securitisation note holders and the documentation should contain provisions facilitating the timely resolution of conflicts between different classes of note holders by the trustees, to the extent permitted by applicable law;</p> <p>iii. To ensure that those identified as having a fiduciary responsibility towards investors as well as the servicer execute their duties in full on a timely basis, remuneration should be such that these parties are incentivised and able to meet their responsibilities in full and on a timely basis.</p> |      |
|  | N. Transparency to investors | <p>i. The contractual obligations, duties and responsibilities of all key parties to the securitisation should be defined clearly both in the initial offering and all underlying documentation;</p> <p>ii. The income and disbursements in the transaction, such as scheduled principal, redemption principal, scheduled interest, prepaid principal, past due interest and fees and charges, delinquent, defaulted and restructured amounts under debt forgiveness and payment holidays, including accurate accounting for amounts attributable to principal and interest deficiency ledgers should be mentioned separately in the report to the investors.</p>           | T, C |

**Note:**

*“S” stands for Simplicity*

*“T” stands for Transparency*

*“C” stands for Comparable*



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### Revisions in the Securitisation Framework

The transactions which complies the STC criteria will be subject to a risk weighting which will be different from other transactions, however, the treatment will differ based on the structure adopted. The Framework has laid down the manner in which risk weight is to be computed for the different models and the same have been discussed below:

#### Floor risk weight

Under all the models, the floor risk weight will be 10% for senior tranches and 15% for non-senior tranches. This floor risk weight for senior tranches was reduced from 15%, from the earlier framework while the Consultation Paper made a recommendation to keep it between 10% - 12%. The floor risk weight to be assigned to non-senior tranches, however remains unchanged.

#### Risk Weight under Internal Rating Based Approach (IRBA)

The supervisory parameter for an exposure in the STC transaction is –

$$p = \max\left[0.3; \left(A + B * \left(\frac{1}{N}\right) + C * K_{IRB} + D * LGD + E * M_T\right) * 0.5\right]$$

Where:

0.3 = P-parameter floor;

N = Effective number of loans in the collateral pool

$K_{IRB}$  = Capital charge of the underlying pool

LGD = Exposure-weighted average loss-given-default of the underlying pool

$M_T$  = Maturity of the tranche

Parameters A, B, C, D and E to be calculated in the following manner:

|                  |                                  | A    | B    | C     | D    | E    |
|------------------|----------------------------------|------|------|-------|------|------|
| <b>Wholesale</b> | Senior, granular (N => 25)       | 0    | 3.56 | -1.85 | 0.55 | 0.07 |
|                  | Senior, non-granular (N <25)     | 0.11 | 2.61 | -2.91 | 0.68 | 0.07 |
|                  | Non-Senior, granular (N => 25)   | 0.16 | 2.87 | -1.03 | 0.21 | 0.07 |
|                  | Non-Senior, non-granular (N <25) | 0.22 | 2.35 | -2.46 | 0.48 | 0.07 |
| <b>Retail</b>    | Senior                           | 0    | 0    | -7.48 | 0.71 | 0.24 |
|                  | Non-senior                       | 0    | 0    | -5.78 | 0.55 | 0.27 |

#### Risk Weight under External Rating Based Approach (ERBA)

The risk weighting under this approach is done based on the nature of the rating. The Framework lays down a matrix for short-term rated structures and long-term rated structures and there are revisions to the matrix as well, which we have presented in a tabular form below:





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### For short term ratings

|                                   | Earlier Framework |         |          |                   | Revised Framework |         |         |                   |
|-----------------------------------|-------------------|---------|----------|-------------------|-------------------|---------|---------|-------------------|
| <b>External credit assessment</b> | A-1/P-1           | A-2/P-2 | A-3/ P-3 | All other ratings | A-1/P-1           | A-2/P-2 | A-3/P-3 | All other ratings |
| <b>Risk weight</b>                | 15%               | 50%     | 100%     | 1250%             | 10%               | 30%     | 60%     | 1250%             |

### For long term ratings

| Rating                         | Existing Framework |        |                    |        | Revised Framework |        |                    |        |
|--------------------------------|--------------------|--------|--------------------|--------|-------------------|--------|--------------------|--------|
|                                | Senior Tranche     |        | Non-senior Tranche |        | Senior Tranche    |        | Non-senior Tranche |        |
|                                | Tranche maturity   |        | Tranche maturity   |        | Tranche maturity  |        | Tranche maturity   |        |
|                                | 1 year             | 5 year | 1 year             | 5 year | 1 year            | 5 year | 1 year             | 5 year |
| <b>AAA</b>                     | 15%                | 20%    | 15%                | 70%    | 10%               | 10%    | 15%                | 40%    |
| <b>AA+</b>                     | 15%                | 30%    | 15%                | 90%    | 10%               | 15%    | 15%                | 55%    |
| <b>AA</b>                      | 25%                | 40%    | 30%                | 120%   | 15%               | 20%    | 15%                | 70%    |
| <b>AA-</b>                     | 30%                | 45%    | 40%                | 140%   | 15%               | 25%    | 25%                | 80%    |
| <b>A+</b>                      | 40%                | 50%    | 60%                | 160%   | 20%               | 30%    | 35%                | 95%    |
| <b>A</b>                       | 50%                | 65%    | 80%                | 180%   | 30%               | 40%    | 60%                | 135%   |
| <b>A-</b>                      | 60%                | 70%    | 120%               | 210%   | 35%               | 40%    | 95%                | 170%   |
| <b>BBB+</b>                    | 75%                | 90%    | 170%               | 260%   | 45%               | 55%    | 150%               | 225%   |
| <b>BBB</b>                     | 90%                | 105%   | 220%               | 310%   | 55%               | 65%    | 180%               | 255%   |
| <b>BBB-</b>                    | 120%               | 140%   | 330%               | 420%   | 70%               | 85%    | 270%               | 345%   |
| <b>BB+</b>                     | 140%               | 160%   | 470%               | 580%   | 120%              | 135%   | 405%               | 500%   |
| <b>BB</b>                      | 160%               | 180%   | 620%               | 760%   | 135%              | 155%   | 535%               | 655%   |
| <b>BB-</b>                     | 200%               | 225%   | 750%               | 860%   | 170%              | 195%   | 645%               | 740%   |
| <b>B+</b>                      | 250%               | 280%   | 900%               | 950%   | 225%              | 250%   | 810%               | 855%   |
| <b>B</b>                       | 310%               | 340%   | 1050%              | 1050%  | 280%              | 305%   | 945%               | 945%   |
| <b>B-</b>                      | 380%               | 420%   | 1130%              | 1130%  | 340%              | 380%   | 1015%              | 1015%  |
| <b>CCC+/<br/>CCC/<br/>CCC-</b> | 460%               | 505%   | 1250%              | 1250%  | 415%              | 455%   | 1250%              | 1250%  |
| <b>Below<br/>CCC-</b>          | 1250%              | 1250%  | 1250%              | 1250%  | 1250%             | 1250%  | 1250%              | 1250%  |

The risk weights for long term rated structures will have to be however, adjusted for tranche maturity and the tranche thickness in the manner provided in the Framework.



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### **Risk Weight under Standardised Approach (SA)**

Under this approach, the risk weighting is to be calculated in the manner provided under the IRBA approach, only that the supervisory parameter will be 0.5 which is 0.3 for IRBA.

### **Conclusion**

The STC criteria along with this relief for high grade issuances will only boost the issuance of senior tranche securities. Since this relief is available only in cases of STC complied securities, which can be considered to be good quality securities, the regulators need not worry about another sub-prime crisis type of situation due to this change.

This change will also help such markets, which are yet to revive like that of Europe, to go ahead with their action plan for reviving the market.

#### **Our other resources on the subject**

1. IOSCO Paper on Simple, Transparent and Comparable (STC) securitization, by Nidhi Bothra – [click here](#)
2. Our articles on securitisation – [click here](#)
3. Our news updates on securitisation – [click here](#)