The impact of Basel II

Pedro Cassiano Santos, Benedita Lima Aires and Tiago Correia Moreira of Vieira de Almeida assess how the new capital adequacy directive will affect structured finance in Portugal

The Revised Framework for International Convergence of Capital Measurement and Capital Standards, published in November 2005 by the Basel Committee on Banking Supervision (Basel II), is the result of a wide-ranging consultation on a new capital adequacy framework, aimed at securing international convergence on supervisory regulations governing the capital adequacy of financial institutions. The Bank of Portugal, and other national regulatory and legislative bodies, have been assessing the practical implications of the changes set forth in the revised framework, and have been preparing the appropriate implementation procedures which were to be carried out by the end of 2006 for most of the revised framework, and, for the most complex measures, by the end of 2007. This article aims to provide an indication of the current implementation procedures of Basel II in Portugal and, bearing in mind the specific securitization framework implied in such a capital adequacy regime, it intends to focus on the expected impact of Basel II on securitization transactions originating in the Portuguese market. With this purpose in mind, it is worth setting out a brief overview of the revised Basel II framework and identifying the major points which influence the new capital adequacy environment.

Basel II

Basel II is sustained by three pillars which are complementary and reciprocally supportive. The first pillar, minimum capital requirements, which initially corresponds to the Basel I Accord, comprises the minimum capital requirements applicable to internationally active banks. In this respect, it represents the calculation of the total minimum capital requirements for credit risk, market risk and operational risk and sets forth rules regarding the use of capital in order to control such risks. Like the Basel I Accord, the new framework establishes a minimum capital ratio for institutions, requiring that their total regulatory capital (that is, their own funds) is at least 8% of its risk-weighted assets. The control of risk is achieved by obliging institutions to identify and quantify the various risks underlying the activities carried out, and to hold an amount of their own funds (that may result from gathering different forms of capital) corresponding to the proportion of such risks.

The second and third pillars are new in the context of the present capital adequacy regime and do not relate to minimum capital requirements, but rather try to compliment such measures by widening the Basel II environment to further supervisors' reviews and to disclosures to other market participants. In fact, pillar two – supervisory review process – demonstrates principles of supervisory review, risk management guidance and supervisory transparency, compelling the national supervisory bodies to assess how institutions are managing capital requirements versus risks, and allowing such supervisors to intervene when necessary. For example, it obliges institutions to perform their activities on higher thresholds than the minimum required. Finally, the rationale of pillar three – market discipline – is to implement disclosure requirements for institutions (supervisors using a wide range of measures which can be used to require institutions to comply with disclosure provisions) in order for market participants to have access to a broader scope of information pertaining to such institutions' capital adequacy status and risk profile.

In the context of pillar one, two alternative approaches, both focused on more elaborate ways of risk-weighing exposures, are set out for calculating the regulatory capital requirements for credit risk, such methods being the standardised approach (SA) and the internal ratings-based approach (IRB). The difference between both approaches is that under the SA, the measurement of credit risk is based on external credit assessments provided by external credit assessment institutions (ECAI), such as rating agencies, whilst under the IRB, institutions can use their own internal ratings systems to quantify all or part (according to the foundation IRB or advanced IRB methods) of the determinants of credit risk and determine the capital requirements, subject to supervisory approval and compliance with eligibility criteria.

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Securitization framework

The new capital adequacy framework also pays close attention to the securitization regime, detailing a separate framework for weighing credit risks and calculating capital requirements in the context of securitization transactions, including, on the one hand, rules for exposures arising from traditional or synthetic securitizations or other economically similar structures and, on the other hand, taking into account both exposures arising from underlying assets being securitized and from financial instruments being issued in the context of the transaction. Within these separate securitization frameworks and bearing in mind the specifics that may arise, institutions will use either the SA or the IRB approaches (as applicable) to calculate credit risks and determine capital requirements arising from securitization exposures. Additionally, under the third pillar of Basel II, it is worth highlighting the general disclosure requirements that institutions are compelled to meet and the requirements for reporting risk management objectives and policies, such as risk management structures, risk reporting and measurement systems, hedging and risk mitigating strategies. Such exercise demands that institutions entering into securitization transactions need to consider the compliance costs of securitization exposures over the life of the transactions carried out.

The basic principle under Basel II is thus that institutions hold regulatory capital against all their securitization exposures and therefore major operational requirements and specific conditions are set out for the treatment of certain components of securitization transactions. Herein we will set out some examples of the treatment of securitization exposures, bearing in mind that this paper is not intended to be an exhaustive description of such instruments.

In relation to traditional securitizations, Basel II sets out certain conditions which need to be satisfied in order for the relevant securitization exposures to be excluded from the calculation of risk-weighted assets, such

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conditions being identified below.

On the one hand, institutions are required to transfer significant credit risk relating to the securitization exposures to third parties, and therefore, they shall not retain the ownership of the receivables that are transferred to the special purpose vehicle (Basel II does not determine what constitutes significant credit risk; however, in this case, one could apply the analogous rule of 10% or less of the original reference portfolio value, which is expressly set out for clean-up calls – see below).

On the other hand, institutions need to ensure that the bankruptcy remoteness rule applies, that is, that the assets are legally ring-fenced, so that the securitization exposures cannot be reached by the originating bank or its creditors, even in an insolvency scenario. This condition also provides that the originating bank cannot maintain effective control over the transferred exposures in that it cannot retain any right to repurchase the exposures and in that it cannot be obliged to retain the risk of the transferred exposures. However, Basel II carves the servicing of the assets and allows for the transferor to maintain the right to servicing exposures, without comprising a control event over such exposures, as otherwise it would be quite cumbersome, from a practical point of view, to service the securitized assets. It is worth highlighting the further requirement of an opinion provided by qualified legal counsel confirming the above points.

Furthermore, the revised framework sets out two conditions relating to the securities issued: (i) the financial instruments issued cannot be obligations of the transferor and therefore investors in these instruments will have no legal right to pursue the transferor for payment, only having access to the pool of assets underlying those instruments; and (ii) the free transferability of the securities, which can be pledged or exchanged by the investors, the transferor having no residual rights to such securities.

Additionally, and still within the scope of traditional transactions, Basel II emphasis three more special conditions applicable to these structures: (i) the transferor may not systematically amend the underlying assets, so that the credit quality of the pool is improved, unless by way of sale in standard market conditions; (ii) institutions are not allowed an increase in a retained first loss position after the transaction origination, as this would increase the originating bank's original exposure; and (iii) no increased yield should be payable to third parties in case of deterioration of the credit quality of the pool. If any of the conditions described above fails, this would result in a regulatory capital charge for the originating bank.

In what concerns synthetic securitization transactions, similar requirements to those detailed above apply, even though this regime specially focuses on credit risk mitigation in the form of collateral, guarantees and derivatives. Regarding collateral, Basel II defines types of eligible collateral for treatment within the context of synthetic transactions, which would include cash on deposit, gold, debt securities rated by an ECAI, debt securities not rated by an ECAI but listed on a recognised exchange, equities and convertible bonds listed on a main exchange, undertakings for collective investments and mutual funds. It is worth noting that Basel II requires that ratings of securitization exposures granted by ECAI must be made available to the public in accessible form.

Regarding guarantees, a major restriction for synthetic transactions is that the special purpose vehicles may not be recognised as eligible guarantors and Basel II provides for a list of entities recognisable as eligible guarantors, such as sovereign entities, public sector entities, banks and securities firms. Moreover, the revised framework provides for a wide range of provisions which, if applied, would attract regulatory changes in the context of synthetic deals, such as clauses which: (a) limit the credit protection or credit risk transference; (b) require the transferor to alter assets in the reference pool in order to improve the average credit quality thereof; (c) increase costs of credit protection or increase the yield payable to third parties due to a deterioration of the underlying pool; (d) provide for increases in the first loss position after the transaction is launched.

Another highlight of this framework is the treatment of clean-up calls, which consists in the right to call given securitization exposures prior to their full repayment, representing an important right to handle scenarios where there is no longer an economic interest in maintaining a given securitization transaction. In order to avoid capital requirements, the following conditions must be satisfied: (a) the clean-up call must correspond to an option at the discretion of the transferor and cannot be of mandatory exercise; (b) it may not be structured so as to avoid allocating losses to certain positions; and (c) it may only be exercised when 10% or less of the original reference pool or issued securities remain outstanding or, for synthetic deals, when 10% or less of the original reference pool value remains.

Under Basel II, and other than as identified above, the securitization framework sets out other requirements and describes treatments for other positions in the context of regulatory capital which are not dealt with in this article, some important components being, for example, second loss positions, eligible liquidity facilities, overlapping exposures, credit risk mitigation and early amortization.

Legal and regulatory framework

Basel II does not have the force of law and is therefore not binding in itself, its binding nature rather being dependent on the relevant countries choosing to transpose it into their domestic provisions.

At an EU level, the aforementioned revised framework has been addressed in Directives 2006/48/EC and 2006/49/EC both from the European Parliament and the Council and both dated June 14. The Directive 2006/48/CE was then implemented in the Portuguese legal framework through Decree-Law 104/2007 dated April 3 2007. In general terms, Decree-Law 104/2007 sets out the obligations concerning the minimum level of own funds and the risk limits which institutions have to comply with. Institutions are thus obliged to comply with the regulatory capital provided therein aiming to protect themselves (and the market in general) against all of their securitizations exposures. Decree-Law 104/2007 is further regulated by various notices and instructions issued by the Bank of Portugal.

From a structured finance perspective, Notice 7/2007 dated April 18 2007, clearly inspired by Basel II, plays the most relevant role by establishing the own funds' requirements that institutions involved in securitization transactions must comply with. The main aim underlying the imposition of such requirements is, in accordance with Basel II, to provide the financial institutions with the means required for the identification and calculation of the risks underlying securitizations, thus imposing a percentage of own funds as suitable to cover such risks, namely stressing out the economic substance of the transactions and not only their legal configuration.

In light of this Notice, together with further regulatory instruments and non-regulatory guidelines from the Bank of Portugal, and as from January 1 2008, the requirements of own funds in the context of secured finance transactions will depend upon the method applied by the originating bank for the assessment of the assigned credits' risks. And as proposed by the Basel Committee, the methods to be used by the Portuguese institutions may be distinguished between the SA (método padrão) or the IRB (método das notações internas).

Following the determination of the method applied by institutions for the assessment of the assigned credits' risks, Notice 7/2007 analyses the essential aspect in respect of the own funds' requirements, that is the transfer, by the originating bank, of a significant amount of the credit risk. Schedule I of the Notice then goes on to set out those which are considered the minimum requirements for the recognition that a significant amount of credit risk was transferred, distinguishing those requirements in accordance with the type of securitizations at stake: traditional securitization or synthetic securitization. Nevertheless, and under the terms set out in the Regulatory Instrument 13/2007 from the Bank of Portugal, such risk transfer is only presumed for each transaction if new and more demanding conditions are met. Among such conditions, it is worth highlighting those which introduce new and more demanding requirements such as: (a) the inexistence of a significant involvement (presumed if the global volume in debt of the underlying exposures assigned in securitization transactions represents a percentage below 20% of the consolidated assets, added with the global volume of the assigned positions, or of the individual assets, in case the institution is not subject to supervision on a consolidated basis); and (b) the inexistence of implicit support in securitization transactions (presumed if the support provided to a securitization transaction by the originating bank, directly or indirectly, is in excess of its predetermined contractual obligations).

In light of this legal and regulatory framework, it is necessary to question the expected impact of Basel II on securitization transactions in the Portuguese market.

Impacts on structured finance

The specific features of the Portuguese securities market – A general criticism which has been drawn upon Basel II is that due to its international appeal, it neglects, to a certain extent, the specificities of legal regimes to be found worldwide. It is important to bear in mind the specificities of each national framework. For example, the rules do not seem to take into account the international differences in insolvency law and the one-size-fits-all approach may, by ignoring such differences, introduce unfair and hardly compliable requirements.

The costs of the minimum capital requirements and the risk assessment – In this particular respect, the main impact of Basel II in Portugal will probably be the costs related to its implementation and the compliance with its rules. With regard to the argument against the one-size-fits-all perspective, when comparing the different financial institutions' scales that may come into action in these transactions, it is not difficult to foresee situations where the compliance of minimum capital requirements by local national institutions represents a barrier to their entry into the market, especially when compared with major international banks whose own funds are usually capable of covering the risks at stake. In this context and taking this point further, the minimum capital requirements may even impose limits on the competition between such different scale market players. This particular issue is more delicate in the Portuguese market where, obviously, the scale assumed by the originating banks is clearly smaller when compared with, for example, major systemic banks. In any case, there is a more general criticism addressed to the minimum capital requirements which are said to be insufficient if, in a worst case scenario, the expected risks come into real existence and the minimum capital is demanded as security.

Moreover, the risk assessments underlying the imposition of own funds' requirements will also tend to increase the costs of compliance with the rules under scrutiny. In fact, the methods to be applied by institutions for the assessment of the assigned credits' risks are composed of highly technical and complex rules and formulas. Credit analysis is thus a demanding and very technical task, involving expensive and expressive costs.

The role of the Portuguese supervisory authorities – Regarding the second pillar, another of the challenges which the Portuguese supervisory authorities will have to face, is the question of the efficiency of both the Bank of Portugal and the Portuguese Securities Market Commission in ensuring the compliance by the market players of the described rules. This efficiency will obviously require cooperation and a permanent dialogue with all the parties involved, including the foreign regulators, investors or depositories.

A continuing debate

Despite the underlying complexity of Basel II, there is no doubt that this highly risk-sensitive framework seeks to improve the existing rules. This is to be done by positioning regulatory capital requirements more closely to the risks underlying the banks activities, and to promote a more sophisticated and flexible approach to capital supervision that encourages banks to identify and quantify the underlying risks, and to improve their ability to manage those risks efficiently. However, as identified above, there are various arguments against the revised framework, and a number of issues remain outstanding. The need for the Basel III Accord to deal with these issues, and the development of international financial markets, is already being included in the market's agenda.