

Consultation paper | CP 18.02

April 2018

Securitization Framework - Internal Assessment Approach



HONG KONG MONETARY AUTHORITY
香港金融管理局

Contents

I	INTRODUCTION	3
II	APPLICATION OF INTERNAL ASSESSMENT APPROACH	4
1	Application under SEC-ERBA	4
2	Scope of application of IAA	5
III	SUPERVISORY APPROVAL	7
IV	OPERATIONAL REQUIREMENTS	8
1	Internal assessment process	8
1.1	Rating methodologies	8
1.2	Policies, procedures and controls	9
2	Independent and regular review	11
3	Specific requirements on individual ABCP programmes	11
V	CALCULATION OF RISK-WEIGHTED AMOUNT UNDER SEC-ERBA (IAA)	13
VI	IMPLEMENTATION TIMELINE	13

I INTRODUCTION

- 1 When consulting the industry in January 2017¹ on the implementation of the capital standards set out in the paper *Revisions to the securitisation framework* of December 2014 (further revised in July 2016) (BCBS SEC Text)² issued by the Basel Committee on Banking Supervision (BCBS), the Hong Kong Monetary Authority (HKMA) at that time proposed not to introduce the internal assessment approach (IAA). Under the IAA, banks can risk-weight unrated securitization exposures to ABCP programmes by using internal credit ratings assigned to the exposures by the banks' internal assessment process.
- 2 After further discussions with the industry in respect of the current and expected development of the ABCP businesses of banks in Hong Kong and the readiness of the industry in implementing the IAA, the HKMA has reconsidered the need of introducing the IAA in Hong Kong and would like to seek the views of the industry on the appropriate approach of implementation.
- 3 This consultation paper outlines the implementation approach proposed by the HKMA. Unless otherwise stated, the terms used in this paper have the same meanings as defined in the Banking (Capital) Rules (BCR) and the Parts, Divisions, sections and Schedules cited refer to those of the BCR.
- 4 The consultation will close on 25 May 2018.

¹ See consultation paper [Revised Securitisation Framework](#) issued in January 2017.

² Available at: <http://www.bis.org/bcbs/publ/d374.pdf>.

II APPLICATION OF INTERNAL ASSESSMENT APPROACH

1 Application under SEC-ERBA

5 The HKMA proposes to incorporate the IAA as part of the SEC-ERBA. After the implementation of the IAA, there will be three types of credit rating that can be used to determine the risk-weight applicable to a securitization exposure under the SEC-ERBA—

- (i) an ECAI issue specific rating assigned by an ECAI to the securitization exposure;
- (ii) an inferred rating determined for the securitization exposure by using an ECAI issue specific rating of another securitization exposure; or
- (iii) an internal credit rating determined for the securitization exposure by using the IAA.

6 In this paper—

- (i) the method of determining the risk-weight under the SEC-ERBA by using the ratings mentioned in paragraph 5(i) and 5(ii) is referred to as “SEC-ERBA (external)” (i.e. the SEC-ERBA currently referred to in the BCR) while the method based on ratings mentioned in paragraph 5(iii) is referred to as “SEC-ERBA (IAA)”; and
- (ii) any reference to “SEC-ERBA” means the SEC-ERBA (external) and the SEC-ERBA (IAA).

7 An authorized institution (AI) should determine whether the SEC-ERBA can be applied to a securitization exposure in accordance with section 15 (an exposure having an internal credit rating determined by using the IAA will be regarded as rated exposure for the purpose of that section). If a securitization exposure is subject to the SEC-ERBA and the exposure has an ECAI issue specific rating, an AI must use this rating to determine the

risk-weight applicable to the exposure. If the exposure does not have an ECAI issue specific rating, the AI may determine the risk-weight by using—

- (i) an inferred rating determined for the exposure in accordance with section 268; or
- (ii) if the exposure falls within the scope of application of the IAA (see subsection 2 below), an internal credit rating determined for the exposure by using the IAA.

- 8 If the SEC-ERBA cannot be used because no rating falling within any of paragraphs 5(i), 5(ii) and 5(iii) is available, the AI must determine the appropriate approach to use in accordance with section 15(3) and (4).

2 Scope of application of IAA

- 9 The HKMA proposes that an AI may use the IAA for the purposes of risk-weighting a securitization exposure only if—

- (i) the AI has an approval granted by the Monetary Authority (MA) to use the IAA for the purposes of risk-weighting securitization exposures (IAA approval) (see section III of this paper);
- (ii) the securitization exposure is a qualified securitization exposure (see paragraph 10 below); and
- (iii) the IAA approval does not contain any condition or limitation that prohibits the AI from risk-weighting the securitization exposure by using an internal credit rating determined under the IAA (see section III of this paper).

- 10 For the purposes of the IAA, a qualified securitization exposure means a securitization exposure that meets all the following requirements—

- (i) the securitization exposure is to an ABCP programme of which the AI is the originator;

- (ii) the securitization exposure does not have any ECAI issue specific ratings and the initial internal credit rating assigned to the exposure by the AI's internal assessment process is at least equivalent to an investment-grade ECAI rating (Para. 75(b) of BCBS SEC text);
 - (iii) the securitization exposure is to a pool of underlying exposures that is an SA pool and none of the underlying exposures is a re-securitization exposure;
 - (iv) the securitization exposure will be required by section 15 to be risk-weighted by using the SEC-ERBA (external) or SEC-SA if the AI does not have an IAA approval;
 - (v) all the debt securities issued under the ABCP programme have ECAI issue specific ratings assigned by any of the ECAIs that have been nominated by the AI for the purposes of Part 7 in the manner as set out in section 267(1) (Para. 75(a) of BCBS SEC text); and
 - (vi) if the AI holds any of the debt securities issued under the ABCP programme, the AI will be required by section 15 to risk-weight the debt securities by using the SEC-ERBA (external) (Para. 75(a) of BCBS SEC text).
- 11 Notwithstanding paragraphs 9 and 10, if any of the due diligence requirements in section 15A is not complied with in respect of the securitization exposure or the ABCP programme, the AI must use the SEC-FBA, instead of the SEC-ERBA or the SEC-SA, to risk-weight the exposure (same requirement as set out in section 15(4)).

III SUPERVISORY APPROVAL

- 12 In line with the requirements set out in paragraph 74 of the BCBS SEC text, the MA may grant an IAA approval to an AI only if both of the following conditions are met—
- (i) the AI has an approval granted by the MA under section 8 to use the IRB approach to calculate its credit risk for non-securitization exposures;
 - (ii) the AI has demonstrated to the satisfaction of the MA that the operational requirements set out in section IV of this paper are met.
- 13 Where appropriate, the MA may attach conditions to the IAA approval granted to an AI or limit the application of the IAA to specific types of securitization exposures or ABCP programmes. For example, the MA may attach a condition that the AI can only use the IAA for securitization exposures to ABCP programmes whose underlying exposures are loans or receivables that are homogeneous and with simple risk profiles.
- 14 Consistent with paragraph 77 of the BCBS SEC text, an AI that has been granted an IAA approval is required to ensure compliance with the operational requirements, and if applicable, the conditions attached to the IAA approval, on a continuous basis. If, after the IAA approval is granted, the MA considers that the AI has ceased to comply with any of the operational requirements or, if applicable, any of the conditions attached to the IAA approval, the MA may suspend the IAA approval granted until he is satisfied that the AI has remedied the non-compliance or revoke the IAA approval. In both cases, the AI must use the SEC-SA or SEC-FBA, as required under section 15, to risk-weight its existing and new securitization exposures that would otherwise be subject to the SEC-ERBA (IAA).

IV OPERATIONAL REQUIREMENTS

- 15 The operational requirements mentioned in paragraph 12(ii) proposed by the HKMA are set out below. These requirements are largely based on the requirements set out in paragraph 75 of the BCBS SEC text.

1 Internal assessment process

1.1 *Rating methodologies*

- 16 The internal credit rating generated by the AI's internal assessment process for a securitization exposure to an ABCP programme (relevant exposure) must be based on rating methodologies of ECAIs (ECAI rating methodologies) that are—

- (i) publicly available; and (Para. 75(e) of BCBS SEC text)
- (ii) developed for the asset type purchased under the programme. (Para. 75(b) of BCBS SEC text)

- 17 The ECAIs concerned—

- (i) must be those that assign ECAI issue specific ratings to the debt securities issued under the programme; and
- (ii) must have been nominated by the AI for the purposes of Part 7 in the same manner as set out in section 267(1).

(Para. 75(c) and (e) of BCBS SEC text)

- 18 The internal assessment process for assessing the credit quality of the relevant exposure must be at least as conservative as the above-mentioned ECAI rating methodologies, in particular with regard to stress factors for determining the credit enhancement level required in order to achieve a particular category of ECAI rating. In this connection, the AI must—

- (i) if the debt securities issued under the programme are rated by more than one ECAI and different benchmarks or assumptions are used by the ECAIs in their rating methodologies in respect of the same risk factor, adopt the more conservative benchmark or assumption in the internal assessment process;
- (ii) consider, to a reasonable extent, all other relevant publicly available ECAI rating methodologies in its credit assessment of the relevant exposure; and
- (iii) if it has access to non-publicly available ECAI rating methodologies, take into consideration these methodologies in its credit assessment of the relevant exposure to supplement the publicly available ECAI rating methodologies, particularly when the non-publicly available ECAI rating methodologies are more conservative.

(Para. 75(e) of BCBS SEC text)

1.2 *Policies, procedures and controls*

19 The AI must have maintained documentation to—

- (i) substantiate that the ECAI rating methodologies selected by the AI are robust and appropriate for use in the AI's internal assessment process for the type of ABCP programme and the type of asset purchased concerned; and
- (ii) explain in detail how the ECAI rating methodologies are applied in the AI's internal assessment process to derive internal credit ratings that correspond to the relevant standards in the ECAI rating methodologies.

(Para. 75(c) of BCBS SEC text)

20 The internal assessment process and the internal credit ratings must in general meet those requirements specified in Part 6 and Schedule 2 that are equally applicable to an internal assessment process for ABCP programmes (e.g. section 152 related to rating definition, criteria and process, section 155(a) related to independence of the rating process, and Schedule 2 section

1(a) related to board of directors / senior management oversight). (Para. 75(b) of BCBS SEC text)

- 21 The AI's internal assessment process must identify gradations of risk and there must be documentation to clearly specify which internal credit rating corresponds to which external rating category of an ECAI. (Para. 75(d) of BCBS SEC text)
- 22 There are policies, procedures and controls in place to verify and confirm that every ABCP programme where internal credit ratings for the relevant securitization exposures are used or to be used for the purposes of the SEC-ERBA (IAA) meets the requirements set out in subsection 3 below. The supporting grounds for the confirmation must be well-documented.
- 23 The AI must monitor any changes in the ECAI rating methodologies used in its internal assessment process. If the changes adversely affect the ECAI issue specific ratings assigned to the debt securities issued under an ABCP programme, the AI must review the internal credit ratings assigned to the securitization exposures to the programme in light of the changes. (Para. 75(e) 2nd bullet of BCBS SEC text)
- 24 The AI must track the performance of its internal credit ratings over time to evaluate the performance of the ratings and make adjustments, as necessary, to its internal assessment process when the performance of the securitization exposures concerned routinely diverges from the internal credit ratings assigned to these exposures. (Para. 75(g) of BCBS SEC text)
- 25 The internal credit ratings generated from the AI's internal assessment process must also be used in its internal risk management processes, including management information system and economic capital system. (Para. 75(b) of BCBS SEC text)

2 Independent and regular review

- 26 There must be regular reviews of the adequacy of the AI's internal assessment process and regular assessments of the validity of the internal credit ratings generated by the process. The reviews and assessments must be conducted by a party that is independent of the parties responsible for designing and operating the internal assessment process and the ABCP programme business line (including those parties responsible for the underlying customer relationships), e.g. internal or external auditors, or the AI's risk management function. (Para. 75(f) of BCBS SEC text)

3 Specific requirements on individual ABCP programmes

- 27 The ECAs chosen to rate the debt securities issued under the ABCP programme concerned do not only include those ECAs that generally have relatively less restrictive rating methodologies. (Para. 75(e) of BCBS SEC text)
- 28 The ABCP programme must have standards on underwriting and structuring of purchase transactions, which must at least cover—
- (i) minimum asset eligibility criteria that, among other things, specify the types of asset that can be purchased. In particular, the criteria must (a) exclude the purchase of assets that are significantly past due or defaulted; (b) limit excess concentration to individual obligor or geographical area; and (c) limit the tenor of the assets to be purchased;
 - (ii) the type and monetary value of the exposures arising from the provision of liquidity facilities and credit enhancements;
 - (iii) loss waterfall; and
 - (iv) legal and economic isolation of the transferred assets from the seller of the assets.

(Para. 75(h) and (j) of BCBS SEC text)

- 29 A credit analysis of the asset seller's credit risk must be performed. The analysis must review, among other things, the following aspects of the seller—
- (i) past and expected future financial performance;
 - (ii) current market position and expected future competitiveness;
 - (iii) leverage, cash flow and interest coverage and, if applicable, debt rating; and
 - (iv) underwriting standards, servicing capabilities and collection processes.
- (Para. 75(i) of BCBS SEC text)
- 30 The aggregate estimate of loss on an asset pool that the ABCP programme is considering purchasing must consider all sources of potential risk, such as credit risk and dilution risk. Moreover, there must be an assessment of the characteristics of the pool including credit quality (e.g. weighted-average credit score), any concentrations to an individual obligor or geographical region, and granularity. (Para. 75(l) of BCBS SEC text)
- 31 If the seller-provided credit enhancement is sized based only on credit-related losses and dilution risk is material for the pool of underlying exposures concerned, the ABCP programme must have a separate reserve established for dilution risk. (Para. 75(l) of BCBS SEC text)
- 32 The size of the required enhancement level is determined taking into account several years of historical information on the underlying exposures concerned, including losses, delinquencies, dilutions and the turnover rate of receivables. (Para. 75(l) of BCBS SEC text)
- 33 The ABCP programme must have collection policies and processes that have taken into account the operational capability and credit quality of the servicer concerned. The programme must mitigate to the extent possible seller/servicer risk through various measures, such as triggers based on current credit quality of the seller or servicer that would prevent co-mingling

of funds and lockbox arrangements that would help ensure continuity of payments to the programme. (Para. 75(k) of BCBS SEC text)

- 34 The ABCP programme must incorporate appropriate structural features that could mitigate the risk of potential credit deterioration of underlying exposures, e.g. wind-down triggers specific to a pool of underlying exposures. (Para. 75(m) of BCBS SEC text)

V CALCULATION OF RISK-WEIGHTED AMOUNT UNDER SEC-ERBA (IAA)

- 35 Under the SEC-ERBA (IAA), an AI must determine the risk-weight applicable to a qualified securitization exposure in accordance with section 265 or 266, as the case requires, by mapping the internal credit rating of the exposure determined under the IAA to an equivalent category of ECAI issue specific rating.
- 36 Current provisions in the BCR related to securitization exposures and the SEC-ERBA (external) (e.g. Divisions 2, 3, 4, 5 and 6 of Part 7) will equally apply to securitization exposures subject to the SEC-ERBA (IAA) and the securitization transactions concerned.
- 37 In particular, if the internal credit rating determined by an AI for a securitization exposure has already taken into account credit protection (including unfunded support provided by the AI) afforded to the exposure, the ABCP programme concerned or the underlying exposures under the ABCP programme, the HKMA proposes that section 267(2), (3) and (4) will apply to the calculation of the risk-weighted amount of the exposure under the SEC-ERBA (IAA) as if the internal credit rating were an ECAI issue specific rating.

VI IMPLEMENTATION TIMELINE

- 38 The HKMA proposes to implement the IAA with effect from 1 January 2019.

- 39 After receiving the industry's feedbacks to this consultation, the HKMA will refine the proposals and prepare a set of draft amendments to the BCR and, if necessary, a draft Code of Practice (to be issued under section 97M of the Banking Ordinance) to translate the relevant requirements contained in the BCBS SEC text into local regulatory requirements. The HKMA expects to consult the industry on these drafts in the second half of 2018. Besides, the standard disclosure templates (specified by the MA under section 6(1)(ab) of the Banking (Disclosure) Rules) for securitization exposures of AIs will also be updated accordingly in consultation with the industry to reflect the implementation of the IAA.