First Treasury Report on Financial Reform — Possible Securitization Impacts

On June 12, 2017, the Department of Treasury issued the first report in a series regarding regulation of the financial system in a manner consistent with Core Principles set forth in Executive Order 13772 signed by President Trump on February 3, 2017. A copy of the report can be found here. The report addresses the regulation of the depositary system, covering banks, savings associations and credit unions. The report makes several findings and recommendations that could impact the future regulation of securitizations.

Changes to Regulatory Capital Rules

The report discusses several potential changes to the regulatory capital rules that could impact securitizations. The report is critical of regulatory capital rules adopted by US regulators that are more stringent than the standards set by the Basel Committee on Banking Supervision (BCBS). There are several aspects of the US risk-based capital rules, as an example, that are more stringent than the Basel version, including a risk weight floor of 20% rather than 15% for securitization exposures. The report also acknowledges that stringent capital and liquidity standards have negatively impacted the market for private label securitizations.

The report specifically finds that the treatment of securitization positions in stress testing and the Comprehensive Capital Analysis and Review (CCAR) can result in banks being required to hold more capital against a securitization position than the bank would be required to hold if it held the entire asset pool on its balance sheet. The report recognized this anomalous result and suggested that this be reviewed.

The report also encourages bank regulators to simplify the regulatory capital rules and emphasizes the Standardized Approach for calculating risk-based capital. For securitization exposures, use of the Standardized Approach would typically mean that capital would be calculated using the Simplified Supervisory Formula Approach (SSFA). While SSFA is easier to use than the Supervisory Formula Approach currently applicable to “advanced approaches banks” (i.e. banks with greater than $250 billion in assets or greater than $10 billion in on balance-sheet foreign exposure), in its current form SSFA has the disadvantage of not differentiating capital treatment based on the creditworthiness of the assets in the pool.

Treasury recognizes the lack of risk sensitivity in the Standardized Approach, and suggests that the bank regulators should consider making appropriate adjustments.

Treasury recommends not adopting any changes to the market risk capital rules on the basis of the BCBS Fundamental Review of the Trading Book (FRTB) Framework without further analysis of the impact of these changes. Generally, the FRTB would impose higher capital charges on securitization positions held by banks in their trading books than the current US trading book rules.

Treasury also suggests in the report that the thresholds for application of certain capital requirements should be reviewed, particularly as these thresholds apply to banks that are larger than $50 billion in assets but that are not designated as globally systemically important banks (G-SIBs). One such requirement would be the supplementary leverage ratio, which currently applies to all banks that are advanced approaches banks under the risk-based capital rules. The supplementary leverage ratio includes all unfunded commitments in its denominator, thereby driving up the cost of banks providing those commitments in connection with securitization transactions they finance.

Liquidity Coverage Ratio “LCR”

Consistent with the recommendations with respect to capital standards, the report suggests that the LCR should apply only to G-SIBs. In addition, the report recommends that non-agency MBS (and, by extension, ABS) with appropriate liquidity characteristics be evaluated for status as high quality liquid assets (HQLA).

Net Stable Funding Ratio "NSFR"

Treasury recommends that the NSFR not be adopted until it can be appropriately calibrated. The report expresses a concern that the NSFR might be duplicative of other existing liquidity standards. If NSFR were to be adopted and additionally certain private label MBS and ABS were to be classified as HQLA under the LCR, such favorable treatment under the LCR would carry over to the NSFR and such assets would require less stable funding as a result.

Volcker Rule

"Covered Funds" are defined under the Volcker Rule to include entities that are exempt from treatment as investment companies under the private exemption contained in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act. Many securitization special purpose entities have been caught within this scope of this definition as a result. In the report, Treasury suggests that this definition is "overly broad" and should be revised to focus on entities that have the substantive characteristics of hedge funds and private equity funds and provide for additional exemptions as necessary.

Risk Retention

Treasury recommends repealing or substantially revising MBS risk retention requirements. If revised rather than repealed, Treasury suggests that a single agency be designated from the six rule-writing agencies to interpret the rule. ABS risk retention requirements are not specifically discussed in the report.

Regulation AB II

The report recognizes the significant additional burdens imposed upon securitization issuers by Regulation AB II. Treasury recognizes the need for loan-level disclosure to maintain transparency and promote investor confidence, but recommends that providing for fewer information fields and creating standardized definitions would provide sufficient transparency while reducing excessive burdens on securitization issuers.

For More Information

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