Article Title: ARCHIVE | Criteria | Financial Institutions | Banks: Changing Capital Requirements for Banks in Securitization Data: The increasing competitive environment and costs associated with credit enhancement may encourage Australian banks to retain a greater degree of risk as they seek to securitize higher-risk asset classes, Standard & Poor's has highlighted in a criteria article titled Capital Considerations in the Australian Securitization Market. The report explains the key analytical issues considered in reviewing asset securitization by banks, and the associated capital issues. These trends may have implications for both the capitalization and the ratings of Australian banks in the future. In the past three years, Australian banks have securitized more than A$10 billion of receivables. To date, these largely have been residential mortgage receivables that effectively have transferred the asset and attendant risks from the bank to investors to the extent that full capital relief has been obtained. However, the possible retention of residual risks and the potential for moral hazard in transactions involving higher-risk assets and more complex structures may result in capital being freed to only a limited extent. Customized structures, variation in the composition and performance of underlying asset pools, and diversity of accounting methodology across different markets results in a unique set of characteristics for each different securitization transaction, arguing against the application of rigid guidelines for capital allocation. MARKET TRENDS AND CAPITAL CONSIDERATIONS With about ten years experience in mortgage securitizations, financial institutions are now testing the Australian market's appetite for securities that are backed by credit card receivables, unsecured consumer loan receivables, and commercial and corporate loans. The trend is not surprising, given that banks and financial institutions can achieve attractive pricing, funding diversification, and improved liquidity management, and also can offload credit risks to credit enhancement providers and, in some cases, investors. Banks also often expect that, by removing risky assets from the balance sheet, the capital required to maintain them will also be freed up -- an attractive prospect to those financial institutions aggressively managing their capital. The inevitable corollary of the "capital relief" argument is the expectation that higher capital ratios may lead to stronger credit ratings. Standard & Poor's approach to capital is conservative but broadly based and does not focus solely on capital ratios. Rating methodology and criteria contemplate a range of financial and business-risk factors in the evaluation of the appropriateness of an institution's capital structure. Capital is more than simply a buffer against losses that fall within the expected range of credit risks in a bank's balance sheet. Standard & Poor's regards capital as a buffer against risks in future asset accumulation and other unexpected events or losses that are likely to result from a bank's day-to-day business activities, both on- and off-balance sheet. In addition to the question of equity relief, securitization raises a number of other capital considerations. To the extent that low-risk mortgage assets are taken off-balance sheet, or commercial credit assets are "cherry picked", for example, the risk profile of remaining on-balance-sheet assets increases, with clear implications for both the bank's debt holders and its capital requirements. Depending on the program's structure and the underlying assets, the asset originator may retain the risk of volatility in residual earnings, which can be almost as significant as if the assets had remained on-balance sheet. The risks borne by both debt and equity holders can be significantly altered by the application of the proceeds of assets sold (for example, if the proceeds are used to make new loans with a different risk profile). Further, the asset originator usually maintains the client relationship, providing other products and services which, even at a very basic level, involves some degree of operational or procedural risk. IDENTIFICATION OF RISKS Banks face the following major risk categories when securitizing assets, including credit risk, liquidity risk, and business risk. Standard & Poor's adopts a discriminative approach its assessment of the affect of securitization on bank credit quality, with a case-by-case evaluation focusing on major risk categories and the extent to which the issuer retains risk. By reviewing actual pool performance and assessing credit and prepayment characteristics relative to both expectations and on-balance-sheet assets, Standard & Poor's is able to evaluate the level of conservatism in underlying assumptions and therefore the appropriate level of capital support. In assessing the implications of the current securitization trend, the criteria article identifies volatility in excess servicing income, first loss positions, additional credit enhancements, and liquidity, servicing, and legal obligations as risk factors confronting Australian banks seeking to securitize higher-risk assets. The criteria article notes that the extent to which capital is released in securitizations can be affected by the retention of residual risks or other obligations that may introduce potential moral hazard. Name branding and operational involvement increase the incentives for a bank to support a program with which it is associated. These incentives impose a cost in the form of economic, if not regulatory, capital. The regulatory position on this issue appears to have been tested recently, with some banks retaining an element of brand-name association while being accorded full off-balance-sheet treatment for regulatory capital purposes. For a full copy of Standard & Poor's criteria article "Capital Considerations in the Australian Securitization Market", contact Lynn Williams on (61) 3-9631-2091.