



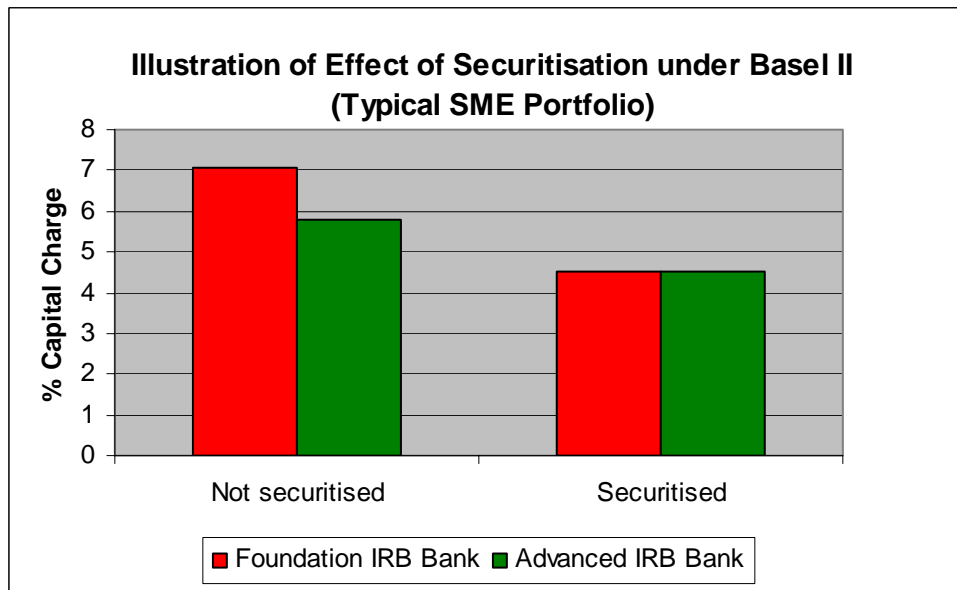
Robin Hood Finance Limited

Securitisation Still Works!

Liquidity, and Better Capital & Risk Management under Basel II

Background

Basel II is now in force. It aligns bank capital more closely with actual risk than Basel I. However, no system is perfect, and various analyses have shown that some asset classes use more capital under Basel II if held as unrated assets on the balance sheet ("OBS") than when they are rated and securitised, even assuming that the same risks are held. One rating agency concludes that *"in most cases a bank acquiring all the tranches(1) of a given securitization would generally have lower capital requirements than the originating bank keeping the underlying assets on its balance sheet"*.



This indicates that there are some inefficiencies in capital allocation under Basel II. In many cases, capital allocation can be optimised using securitisation, without selling or paying for protection on the entire asset pool.

(1) The different levels of risk in a portfolio resulting from a securitisation-type analysis, e.g. AAA, AA, A etc.

Liquidity

Another reason to consider applying a securitisation-type analysis to assets is that rated collateral is often acceptable for repo funding with central banks. The Bank of England now accepts AA- or better RMBS as repo collateral.

88.5% by value of all European securitisations in H1 2007 were AA or AAA, so unrated assets can produce high-rated collateral.

Research

Several rating agencies have performed analyses of the relationship between securitisation and Basel II. Some of their conclusions are:

- Basel II charges for unrated tranches (under the Supervisory Formula) are typically much higher than RBA (Ratings Based Approach, which is used under Basel II for rated securitisations) for tranches between AA and BB. For BBBs, the charges are between 9 and 16 times higher. This suggests that there is a significant potential benefit in this area of the risk spectrum.
- Some asset types show more disparity between Basel II and RBA than others; for example, entire CMBS (commercial property) pools in one study showed capital used in Basel II OBS 3.8 times higher than RBA. Credit cards also showed over 3 times more capital used under Basel II OBS than RBA

What does this mean for banks?

- In brief, it means that banks can gain the benefits of **improved Basel II capital efficiency, and potential funding**, as well as risk analysis by an international rating agency. The bank can decide to transfer the risk on any or all of the tranches to the market, or use them for repo funding, at a time of its choosing, and much more rapidly than starting from scratch.
- Banks gain an objective view of their risk from a qualified third party.
- What risk, if any, should be transferred to the market? Some banks are taking the view that there is little value from a capital perspective in transferring risk on AAA tranches, which can use as little as 0.56% capital and are, by their nature, low risk. As an illustration: in early 2007, ABN Amro issued a Dutch SME CLO (bonds based on a pool of loans to SMEs). The AAA tranche was retained, but the 5.5 year BBBs sold.
- The regulator would of course have to agree to the new capital treatment, but as Standard & Poor's writes: *"provided regulators recognize some risk transfer related to the disposal of some tranches, the capital benefits will be more than proportional to the risk transferred"*.
- Banks will also be aware that the Basel II effect is dynamic, i.e. capital charges increase if downgrades occur. Downgrades could have a significant impact on portfolio capital charges, which is another argument for rating and transferring the riskier pieces. Equity or first loss risk is of course unrated, and not affected by downgrades. Standard & Poor's again: *"The fact that a one-notch change in the average rating of a corporate portfolio would translate into a more than 10% increase or decrease in capital requirements for exposures on the balance sheet could be a powerful incentive to securitize for a number of banks"*.
The message: the securitisation approach can also help with capital stability, which could be called the "management of capital charge volatility".

How do we do this?

The process described here means that securitisation is a 2-step process:

- Analysis and rating
 - Risk transfer or funding as required
1. Robin Hood Finance Ltd. ("RHF") as independent advisor helps the bank to clarify its objectives, and identify which asset pools are most appropriate for analysis and tranching;
 2. RHF assists the bank in identifying an appropriate rating agency with which to work. No arranging bank is involved at this stage;
 3. The bank, RHF and the rating agency chosen by the bank perform due diligence, analysis and tranching. This should provide sufficient information for the bank to decide which risk tranches it would be most efficient to transfer to the market;
 4. If the bank wishes to transfer risk on, or raise funding via any or all of the tranches, RHF will advise on choice of counterparty, appropriate structure, pricing etc; and the rating agency will perform final analysis and issue rating letters and presale reports as appropriate to get the deal done.