May 31, 2001

The Bank for International Settlements
Basel Committee on Banking Supervision
Centralbahnplatz.2
4022 Basel
Switzerland

Re: The New Basel Capital Accord—ABS Issuers Comments

Ladies and Gentlemen:

The organizations listed on Schedule I (the "*Commenting Group*" or "*we*") wish to thank the Basel Committee on Banking Supervision (the "*Committee*") for this opportunity to comment on the consultative package released by the Committee in January of this year relating to the new Accord. In general, we support the Committee's efforts to more closely align bank capital requirements with the actual risks that capital is meant to cover.

The Commenting Group includes banks or affiliates of banks that are substantial issuers of asset-backed securities and other organizations with substantial involvement in the issuance of asset-backed securities by banks. As a result, among the members of the Commenting Group are many of the institutions that would be most significantly affected by the portions of the consultative package that address the treatment of originating banks in asset securitizations. As issuers or persons otherwise involved in bank issuance of asset-backed securities, we are also interested in the treatment of banks that invest in those securities.

The Commenting Group is concerned that the current December deadline for publication of the new Accord is causing very important and complex matters to be handled with far too much haste. At this writing, several important elements of the approach relating to securitizations (including the internal ratings-based approach discussions and proposals for synthetic securitizations) have not been formally exposed for consultation. We believe that it is imperative that we and other concerned parties be able to comment on concrete proposals and that the Committee and its staff have the opportunity to give due consideration to those comments.

Since we believe that the Committee will receive significant comments and, we hope, make material changes to the January proposal, the Committee should also circulate another full consultative package before moving to a final Accord, so that interested parties will have an opportunity to review and comment on changes made in response to other parties' initial comments. Given all of the above, we believe that the December deadline should be set aside to allow additional time for thoughtful analysis and input from industry participants.

Executive Summary

We have summarized our principal comments on the consultative package below:

1. We oppose a "managed assets" capital requirement on securitized assets in revolving structures involving an early amortization feature (see Part 1 below).

2. As to the treatment of seller-provided credit enhancement (see Part 2 below), we:

   - Oppose a dollar-for-dollar capital requirement in excess of current low level recourse rules.

   - Oppose different treatment for banks holding similar positions in terms of credit risk in varying roles as originator or investor, respectively.

   - Oppose the requirement that a third party hold the first loss position in order for an originating bank to treat retained second loss positions as direct credit substitutes.

3. We recommend a 0% credit conversion factor for servicer advance obligations that benefit from provisions designed to reduce or fully mitigate the risk of servicer loss as well as for servicers who do not sponsor the securitization in which the serviced assets are held (see Part 3 below).

4. We recommend a number of technical improvements to the "clean break" requirements (see Part 4 below).

5. We support the external ratings based approach for investing banks, but also support enhancements to that approach (see Part 5 below).

6. We oppose any *ex ante* additional capital charge for implicit or residual risks other than in response to a bank actually providing implicit recourse (see Part 6 below).

Comments

1. Managed Assets Approach (paragraph 523).[1/]

The Commenting Group is strongly opposed to the Committee's proposal to require banks to hold capital (with a 10% or 20% credit conversion factor) against assets securitized in transactions that include an early amortization feature, which we refer to below as the "*managed assets approach*".

[1/] Unless otherwise specified, all three digit paragraph references below refer to paragraphs of the main *Consultative Document on the New Basel Capital Accord*, and one or two digit paragraph references refer to paragraphs of the separate *Consultative Document on Asset Securitisation*. Where the securitization chapter in the main document and the separate securitization document both contain substantially similar text, we comment here only on the main document, since we assume that more closely approximates the Committee's intended text for the final new Accord.

We object to the managed assets approach on several grounds, including that:

- Typical early amortization features do not constitute credit recourse.
- The additional minimum capital required under the managed assets approach would be duplicative of capital currently required for sales with recourse under most countries' bank regulatory regimes.
- The managed assets approach seems to be largely aimed at liquidity concerns, not the credit risks that Pillar I of the new Accord is designed to address. These types of issues are better addressed under Pillar II.
- The liquidity management issues created by master trust funding are not so different from other funding sources as to justify this additional capital charge.
- Banks frequently have multiple options to deal with a loss of funding due to an early amortization. For instance, credit card issuers generally have the contractual right to reduce or terminate credit lines.
- Any regulatory benefits that might be gained by imposing this additional and excessive capital requirement would be outweighed by increases in the cost and/or decreases in the availability of credit that we believe would result if the new requirement were imposed.

We believe that existing disclosure practices, combined with case by case supervisory discussions of liquidity and contingency planning, represent an adequate and appropriate regulatory approach to the issues created by early amortization features.

Each of our points of objection to the managed assets approach described above are more fully described in, and supported by, the letter that some of us submitted to the Committee in connection with its June 1999 consultative paper. We have attached that letter to this one, and by doing so we are re-submitting that letter as a comment on the managed assets approach as it is described in the January consultative package.

2. Seller Provided Credit Enhancement.

2.1. Limitation of Capital to "On Balance Sheet" Requirement (paragraph 520).

Although the Consultative Paper does not discuss the point at length, it appears that the Committee intends to limit the capital required under the standardized approach for first loss and other residual or retained interest positions to the amount of capital required for the related underlying assets if they were held on the originating bank's balance sheet. Specifically, Section 520 states: "originators and loan servicers that provide credit enhancement must deduct the full amount of the enhancement from capital, *taking into account the risk-based capital charge that would have been assessed if the assets were held on the balance sheet*" (emphasis added). We understand from discussions with staff for the Committee that the italicized language was intended to limit the capital requirement for credit enhancements to the on-balance sheet requirement for the whole pool. We support that decision and request that the Committee clarify

this point in the final Accord. For instance, in the phrase quoted above, the phrase "taking into account" could be changed to "limited to".

We note that the U.S. Federal bank regulatory agencies proposed eliminating the on-balance sheet capital charge as a cap in a September 2000 release. We trust that the Committee would provide fair public notice and an opportunity for comment before implementing a change of that type in the final Accord. We strongly oppose such a change and a number of us have previously provided comments to the U.S. regulators on the point.

2.2. Second Loss Positions (paragraphs 520-522).

The Commenting Group's primary concern with this portion of the consultative package is that it continues to treat banks holding similar positions differently. In particular, paragraph 521 states that in order for a second loss credit enhancement that is retained by an originating bank to be treated as a direct credit substitute there must be significant first loss protection that has been provided by a third party. As a result, an identical second loss position held by two different banks (one the originator and one an investor) could have radically different capital treatment.

For example, assume a securitization of $100 million of installment loans where:

- the first loss position is a combination of an excess spread/interest-only strip asset and a spread account which are available to cover future losses up to a maximum of $4 million, both of which are retained by the originating bank; and

- the only other positions are a $4 million junior (second loss) class of securities rated "A" or its equivalent and a $96 million senior class of securities rated "AAA" or its equivalent.

Under the standardized external ratings-based approach in the proposal, an investing bank (other than the originating bank) that held the junior securities could assign them a risk weight of 50%. On the other hand, if the originating bank retains the junior securities it appears that the junior securities would be deducted from capital because the first loss protection is not provided by a third party.

This divergence in capital treatments creates a tremendous artificial incentive for originating banks to sell second loss positions, even when those second loss positions bear a market coupon that is higher than the originator's on-book cost of funds. As the Committee moves towards its goal of more closely aligning regulatory capital requirements with risk, these types of artificial incentives should be eliminated. The capital requirement for a securitization position under the standardized approach should be the same for any bank, regardless of whether or not it is the originator. This is particularly clear for external ratings, where the external rating agency provides an independent check on the credit quality of a position.

Also, an originating bank that has a retained second loss position externally rated in one transaction should be able to use that tranche as a benchmark to support equivalent capital treatment on substantially similar tranches in other transactions. For instance, assume a bank has issued two series of floating rate securities out of a revolving credit card master trust, each with

an $80 million Class A (rated AAA in each case), a $10 million Class B (rated A in each case) and a $10 million Class C (rated BBB in the first series and unrated in the second). Neither series has any credit enhancement other than the subordination of the various classes and excess spread.

Because there is a single master trust, proportional interests in the exact same receivables support each series. In light of these facts and the identical enhancement structure, the originator should be able to impute the BBB rating received on the first Class C to the second unrated Class C. This should also be permitted if there are separate asset pools (for instance in two separate securitizations of installment loans) where the originator reasonably believes that the asset quality is substantially the same and the enhancement structure required by the rating agencies supports that belief.

3. Servicer Advances (paragraph 522).

The Commenting Group opposes the imposition of a blanket capital requirement on banks with servicer advance obligations. Instead we believe that servicer advances in securitization transactions should be reviewed based on the specific terms of each transaction and the general rules relating to commitments.

Paragraph 522 suggests that all servicer advance provisions be treated as credit enhancement unless the servicer has a right to all subsequent collections on the securitized assets and any available credit enhancement and all other payments to investors are subordinated to the reimbursement of the servicer for any such advances. In addition, even given the existence of such risk mitigants, servicer advances under the proposal could, at best, be treated as commitments and "converted to an on-balance-sheet equivalent at 20% and generally risk-weighted at 100%". In view of the Committee's goal to align capital requirements with the risk of related securitization positions, imposing such capital requirements on all servicer advance positions is unreasonable due to the various structures intended to reduce all or most of the risk associated therewith.

Accordingly, the Commenting Group believes that at least three categories of servicer advance obligations should be excluded from any new capital requirement:

- First, in many transactions (particularly private residential mortgage securitizations), the servicer is required to advance delinquent principal and interest to investors unless the servicer reasonably determines that an advance would eventually not be recovered from late collections or liquidation proceeds. The servicer then has a first priority claim to late collections or liquidation proceeds on the related receivable. Importantly, if the servicer determines that an advance that it expected to be able to recover as described above will not in fact be recovered in that manner, the servicer is entitled to a priority reimbursement for the shortfall from collections on other receivables in the transaction. The risk to a servicer in making advances of this type is close to zero, and we think that in these circumstances any "commitment" that the servicer has is unconditionally cancelable, since the servicer does not have to make the advance if it does not expect to recoup it.

- Second, in some transactions, servicer advances are wholly discretionary. Here it is even more clear that any "commitment" that exists is unconditionally cancelable and therefore should have a credit conversion factor (and resulting capital requirement) of zero.

- Third, where a bank continues to service assets that it has sold to an unrelated third party, and the third party has securitized the assets, we do not think that the servicer should have any capital requirement, regardless of the nature of the servicer's advance obligations. The arm's length terms of such a sale provide independent assurance that the servicing bank is acting on a purely contractual basis and not seeking to support the receivables.

4. Clean Break Requirements (paragraph 518).

The Commenting Group agrees that a bank should have to meet minimum criteria to remove securitized assets from its risk-based capital calculation. However, we do not think that the Committee should impose an additional supervisory level of clean break requirements, particularly in jurisdictions (such as the U.S.) that have well-defined accounting and legal standards for derecognition of financial assets. Any particular standards imposed by the Committee will create another layer of complexity and interpretation and generate unnecessary incremental transaction costs.

If the Committee decides to retain language along the lines proposed in paragraph 518 of the January proposal, we have the following comments relating to that language.

4.1. True Sale.

First, the introductory language to paragraph 518 requires a "true sale." We recommend that the Committee avoid using that phrase, as "true sale" has a very specific legal meaning, at least in the United States, and is not appropriate in all circumstances. For instance, the U.S. Federal Deposit Insurance Corporation recently adopted a rule that permits banks to isolate assets in the manner described in subparagraph 518(a) in circumstances where counsel would not necessarily be able to render a "true sale" opinion. Similarly, the U.S. Congress appears to be close to passing into law an amendment to the U.S. Bankruptcy Code that would provide a statutory isolation safe harbor but would not lead to a conclusion that there has been a true sale within the established legal meaning.

4.2. Qualifying SPVs and Transfer Restrictions.

Second, we request that the Committee reword paragraph 518(b) to more closely parallel paragraph 9(b) of U.S. Statement of Financial Accounting Standards No. 140 ("SFAS 140") and specifically to permit all of the flexibility that paragraph 9(b) permits. We do not think it is necessary for the Committee to specify any requirements for the type of entity to which the transfer is made, since some securitization transfers do not even involve special purpose entities. For example, a bank or other financial institution could purchase a senior undivided securitization interest in a pool of assets directly from the originator. If the Committee thinks it necessary to provide any sort of definition of special purpose entities, we recommend a much

more general one, such as the one used for "issuer" in the amendment to the U.S. Bankruptcy Code mentioned above.

Section 518(b) currently requires that the transferee be a "qualifying" special-purpose vehicle, which a footnote to paragraph 13 indicates will be "defined by national accounting standards." In the United States, that would mean the definition in SFAS 140, from which much of the text of paragraph 518 was apparently taken. In connection with any "clean break" criteria set forth in the new Accord, and relating to the person or persons to whom transfers must be made in order to achieve such a clean break, we strongly oppose importing all of the SFAS 140 requirements for QSPE status into the risk-based capital regime.

Paragraph 518(b) closely parallels paragraph 9(b) of SFAS 140, which reads in full as follows:

> "b. Each transferee (or, if the transferee is a qualifying SPE (paragraph 35), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor (paragraphs 29-34)."

The general point of paragraph 9(b) is that for the transferor to have surrendered control, the transferee should be free to further alienate the assets. The U.S. Financial Accounting Standards Board ("FASB") came up with the concept of a QSPE to accommodate an important market exception to that requirement. Many securitization SPEs that are transferees of receivables do not have the right to further alienate the receivables. FASB decided that was acceptable so long as the receivables, once transferred to the SPE, were essentially locked there, so that investors who exchanged beneficial interests in the SPE were effectively exchanging beneficial interests in the underlying receivables. In the context of SFAS 140, the QSPE concept is predominantly a concept relating to alienability of the receivables.

But in paragraph 518(b) the QSPE concept is used in a different context, as the type of entity to which a transfer must be made. This is inconsistent with paragraph 9(b) of SFAS 140, which does not require that the transferee be a QSPE in all circumstances. The transferee only has to be a QSPE if the transferee does not obtain the right to pledge or exchange the transferred assets, free of disqualifying constraints. In other words, if a transferee does have those rights, then it does not have to be a QSPE. In fact, U.S. securitization practice makes use of SPEs that are not QSPEs but who have the right to transfer the receivables (or interests therein) that they purchase. Multi-seller asset-backed commercial paper conduits are an important example of SPEs that generally are not QSPEs. Because FASB designed the rules for QSPEs with transferability issues, rather than insolvency isolation, in mind, there are many technical requirements for QSPEs that are burdensome in practice and are not necessary for the purposes of a clean break.

4.3. Additional Clean Break Requirements.

Finally, we note that the "clean break" requirements in the consultative paper are described as "minimum" operational requirements. We believe that, in the absence of special

national legal considerations, there should be no clean break requirements other than those specified in the Consultative Paper. The specified requirements are sufficient to effectively transfer the risk of, and control over, the assets from the bank. Therefore, upon satisfaction of these conditions, we believe that a bank should be able to remove these assets from its risk-based capital calculation. If the language was used to indicate that even if a bank met the three articulated "clean break" requirements, for other reasons (such as providing implicit recourse or otherwise providing credit enhancement in a way that undermines a "clean break") it might still be required to include these assets in its risk-based capital calculation, we believe it would be better to explicitly reference these other sections of the consultative package, rather than imply that additional operational requirements could be added to those articulated.

5. Investing Banks (paragraphs 525-526).

The Commenting Group strongly supports a ratings based approach for securitization positions. This is an important step forward in matching regulatory capital requirements to the true risk of assets. The Commenting Group, however, advocates more gradients in the risk weighting grid and lower risk weights for some or all the gradients included in the Committee's proposal. However, even without such advocated changes, the grid proposed by the Committee is a tremendous improvement over the current regime. The Committee should at least adopt that grid as proposed, but we hope the Committee will also enhance the grid by adding more risk weights and reducing the risk weight for some rating levels, as appropriate.

6. Implicit/Residual Risk (paragraph 545).

The Commenting Group strongly opposes any *ex ante* minimum capital charge related to implicit and residual risks for securitizations. The securitization process allows the credit risk associated with a pool of loans to be allocated among a variety of different parties, enhancing liquidity within the banking system. To arbitrarily assess a capital charge to originators of all securitization transactions for implicit/residual risk disregards the risk transfer process inherent in securitization structures and assumes that all financial institutions will behave inappropriately.

7. Conclusion.

The Commenting Group supports the Committee's continuing efforts to modify capital requirements to truly reflect the relative risk associated with various assets. We look forward to continuing to work with the Committee and its staff on the proposals set forth in the Consultative Paper. We believe that our continuing dialogue will result in regulatory requirements that provide for the maintenance of prudent levels of capital without disadvantaging banks in the fiercely competitive global capital markets.

With your permission, we would appreciate the opportunity to add to the institutions included as members of the Commenting Group as additional institutions have an opportunity to obtain internal approval for support of the positions discussed in this letter.

Schedule I

List of Commenting Group Members

The foregoing comments are respectfully submitted by the following institutions:

Alston & Bird LLP
Bank of America
BANK ONE CORPORATION
Barclays Capital Inc.
Citigroup Inc.
Deutsche Banc Alex. Brown Inc.
FleetBoston Financial
JP Morgan Chase & Co.
Mayer, Brown & Platt
MBNA America Bank, N.A.
Morgan Stanley Dean Witter & Co.
National City Corporation
Orrick, Herrington & Sutcliffe LLP
People's Bank
Providian Financial Corporation
Spirit of America National Bank
Wachovia Bank, N.A
Wells Fargo & Company
World Financial Network National Bank

Submitted on or about March 31, 2000

The Bank for International Settlements
Basel Committee on Banking Supervision
Centralbahnplatz.2
4022 Basel
Switzerland

Re: A New Capital Adequacy Framework: Consultative Paper issued by the Basel Committee on Banking Supervision—Master Trust Comment

Ladies and Gentlemen:

The organizations listed on Schedule I (the "*Commenting Group*" or "*we*") wish to thank the Basel Committee on Banking Supervision (the "*Committee*") for this opportunity to comment on its June 1999 Consultative Paper on a New Capital Adequacy Framework (the "*Consultative Paper*"). In general, we support the Committee's efforts to more closely align bank capital requirements with the actual risks that capital is meant to cover.

However, we are strongly opposed to the Committee's proposal to require banks to hold capital (with a 20% credit conversion factor) against assets securitized in transactions that include an early amortization feature.[1] In this letter we comment only on that proposal, which we refer to as the "*managed assets approach*."

The members of the Commenting Group all have substantial credit card programs, which we finance in part through securitizations that include early amortization features, or are otherwise involved in credit card securitizations. As a result, we are among the institutions that would be most significantly affected by the adoption of a managed assets approach. We believe we are also among the best-qualified parties to speak to the purposes and effects of early amortization provisions.

We object to the managed assets approach on several grounds, including that:

- Typical early amortization features do not constitute credit recourse.

- The additional minimum capital required under the managed assets approach would be duplicative of capital currently required for sales with recourse under most countries' bank regulatory regimes.

- The managed assets approach seems to be largely aimed at liquidity concerns, not the credit risks that the risk-based capital system is designed to address.

[1] See Annex 2 to the Consultative Paper, paragraph 36.

- The liquidity management issues created by master trust funding are not so different from other funding sources as to justify this additional capital charge.

- Any regulatory benefits that might be gained by imposing this additional and excessive capital requirement would be outweighed by increases in the cost and/or decreases in the availability of credit that we believe would result if the new requirement were imposed.

We believe that existing disclosure practices, combined with case by case supervisory discussions of liquidity and contingency planning, represent an adequate and appropriate regulatory approach to the issues created by early amortization features.

We will discuss our objections to the managed assets approach in further detail in *Part II* below. Before we do so, it may be helpful to give a brief description of a typical credit card master trust with a bank seller.

I. Description of a Typical Credit Card Master Trust.

In a typical credit card securitization, a bank with a credit card program designates a set of credit card accounts and transfers balances in those accounts to a master trust. The bank sells only the balances arising in the accounts and does not sell the account relationships. Additional accounts may from time to time be added to the designated set of accounts from which balances are transferred to the trust. Subject to specified conditions, accounts may also be removed from that set.

Unless an account has been removed in accordance with the specified conditions, all balances arising from new purchases or other advances made under the account continue to be transferred to the trust so long as the trust remains in existence. This avoids the administrative difficulty of dividing account collections between balances that are in the trust and those that are not. It is also consistent with the ongoing issuances of securities by a master trust.

From time to time, the master trust issues series of investor certificates, which represent beneficial interests in the trust and typically include at least two classes of interests: Class A Certificates (generally rated AAA or its equivalent); and Class B Certificates (generally rated in the A category). Often a series includes a third class of interest, referred to as a "Collateral Interest", which is effectively an uncertificated Class C "Certificate." Collateral interests are generally rated in the BBB category or structured so that the parties believe that they could be rated in that category.

Recently, some banks have begun to securitize through trusts that issue notes instead of certificates. This difference in form does not materially change the substance of these transactions as summarized below.

A. Invested Amounts and Allocation Percentages.

The investors' principal investment in the trust is limited to the initial principal amount of their certificates, minus

(a) principal payments received by the investors (or funds set aside for such payments), which generally do not occur during a "revolving period" that lasts for a number of years after the particular series of certificates is issued;

(b) the investors' share of charged off receivables that are not covered by investor finance charge collections or credit enhancements; and

(c) in the case of junior classes, principal collections allocated to that class that are reallocated to cover claims of the more senior classes.

The net amount at any time determined above for a particular class is often called that class's "*invested amount*," and the sum of the class invested amounts in a series is called the series' invested amount.

The mechanisms referred to in clauses (b) and (c) above are described further in *Part I.B*. below. The point we wish to make now is that an investor's investment gives the investor a claim of a generally fixed principal amount on the pool of receivables held by the trust. That claim is subject to reduction once an investor begins to receive its investment back and through credit loss sharing and allocation mechanics.

Unlike the investors' claims on trust assets, which tend to remain constant from day to day, the aggregate receivables balances in a trust tend to vary each day, as cardholders make new purchases using their cards and cardholder payments are received. These fluctuations are generally reflected in the size of the seller's interest in the trust. The amount of the seller's interest on any day can be calculated as the aggregate principal receivables in the trust minus the series invested amounts of all then outstanding receivables. For instance, assuming a trust with one outstanding $500 million series of investor certificates, the seller's interest would vary as shown in Table 1 below, as the aggregate principal receivables in the trust varied.

Table 1. Illustration of Seller's Interest Calculations.

	Day X	**Day Y**	**Day Z**
Aggregate principal receivables	$550,000,000	$560,000,000	$545,000,000
Series invested amount	$500,000,000	$500,000,000	$500,000,000
Seller's interest	$50,000,000	$60,000,000	$45,000,000

The seller's interest is not, however, meant to absorb the investors' share of credit losses on the securitized receivables. To keep it from doing so, a share of the credit losses is allocated to each series as described below. The seller receives a share of collections commensurate with its pro rata interest in the trust, and those collections are not available to protect investors from credit losses. The seller's percentage of collections equals 100% minus the applicable investor percentages for each outstanding series, as described below.

The investors in each series are entitled to a fraction of the collections on the securitized receivables and are allocated a fraction of the credit losses on the securitized receivables. For administrative convenience, the percentage used to allocate collections and credit losses is generally set at the end of each month for all activity occurring in the following month. The percentage used is generally called the "*floating allocation percentage*," which equals the percentage equivalent of the following fraction:[2]

$$\frac{\text{series invested amount}}{\text{aggregate principal receivables}}$$

For instance, given the information in Table 1 above, if days X, Y and Z were all the final days of calendar months, then the allocation percentage for the immediately following months (rounded for convenience of presentation here) would be 90.9% (500/550), 89.3% (500/560) and 91.7% (500/545).

The one exception to this formula is that once the revolving period for a series ends, the allocation percentage used to allocate principal collections to the series is determined using the series invested amount at the end of the revolving period as the numerator. This is necessary to keep the pay down period from becoming excessively long, as it would be if investors received a smaller and smaller share of principal collections as their remaining investment was reduced. It is not meant to shift risk from

[2] Some trusts instead allocate all collections and credit losses among the various series and then split collections and credit losses between investors and the seller within each series. This is accomplished with some variation on the following formulae:

- allocations among the series are made with a "series allocation percentage" that is defined as:

$$\frac{\text{series invested amount}}{\text{sum of series invested amounts for all outstanding series}}$$

- allocations to investors are then made from the collections and credit losses so allocated to the series using a floating allocation percentage (or principal allocation percentage, as discussed further below in the text) that is defined as

$$\frac{\text{series invested amount}}{\text{series allocation percentage * aggregate principal receivables}}$$

On a net basis, these formulae generally put the investors and the seller into pretty much the same position as the formulae discussed in the text.

investors back to the seller. The effect on investors of a declining share of principal collections is discussed further below.

In the ordinary case, a bank does not expect the aggregate assets in a master trust to decline just because a particular series of investor certificates has finished its revolving period. The bank expects the aggregate principal receivables in the trust to remain level or grow. This is because all of the balances arising in existing and new accounts designated as part of the trust portfolio continue to be transferred to the trust.

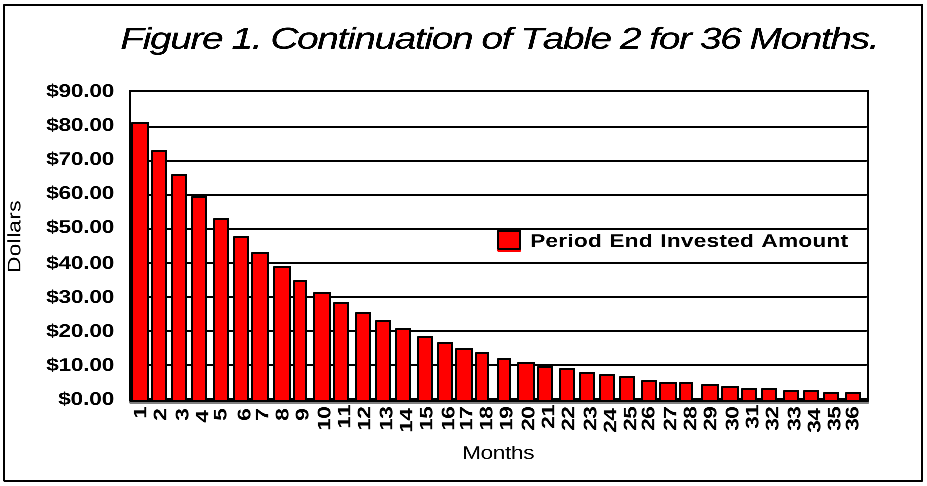
In this expected case, if the numerator for determining the allocation of principal collections to a series were not fixed at the end of the series' revolving period, then the share of principal collections allocated to the series would grow smaller and smaller over time. This is because the numerator for determining the investor allocation percentage would decrease every month, while the denominator would remain steady or grow. This situation is illustrated in Table 2.

Table 2. Principal Allocations with Declining Numerator and Steady Denominator.

Month	Pool size	Beginning Invested Amount	Investor Percentage	Principal Collections	Investor Share	Period End Invested Amount
1	$100.00	$90.00	90.00%	$10.00	$9.00	$81.00
2	$100.00	$81.00	81.00%	$10.00	$8.10	$72.90
3	$100.00	$72.90	72.90%	$10.00	$7.29	$65.61
4	$100.00	$65.61	65.61%	$10.00	$6.56	$59.05
5	$100.00	$59.05	59.05%	$10.00	$5.90	$53.14
6	$100.00	$53.14	53.14%	$10.00	$5.31	$47.83
7	$100.00	$47.83	47.83%	$10.00	$4.78	$43.05
8	$100.00	$43.05	43.05%	$10.00	$4.30	$38.74
9	$100.00	$38.74	38.74%	$10.00	$3.87	$34.87
10	$100.00	$34.87	34.87%	$10.00	$3.49	$31.38

In the illustration above, the aggregate principal collections over the period shown (10*$10) equals the aggregate principal receivables at the beginning of the period ($100), yet investors are not paid out at the end of the period. This is because their share of collections declines over time as their declining invested amount makes up a smaller and smaller percentage of the pool balance.

In fact, because the investors' share of collections keeps declining, it would take an extraordinarily long time to pay back the investors' investment. In many scenarios, using the declining series invested amount as an allocation numerator creates an asymptotic function, meaning that the slope of the decline in the invested amount keeps decreasing as it approaches zero in such a way that it would theoretically never reach zero. This is illustrated in Figure 1 below, which continues the illustration in Table 2 through 36 months.



This situation is avoided by fixing at least the numerator in a series' principal allocation formula at the end of the revolving period for the series. Some trusts also fix the denominator. In either case, we refer to the resulting percentage below as the "*principal allocation percentage*."

B. Allocations of Collections and Credit Losses.

Collections and credit losses on the accounts designated to a master trust are allocated between the selling bank and investors. The percentages used for these allocations are generally as follows:

- Finance charge collections and credit losses are at all times allocated to each series of investor certificates based on the floating allocation percentage for the series.

- Principal collections are allocated to a series based on the floating allocation percentage during the revolving period and based on the principal allocation percentage after the revolving period ends.

A bank that issues credit cards expects the finance charges and other revenues from its credit card business to cover the credit losses on its credit card portfolio. Similarly, investors in master trust certificates are expected in the ordinary course to cover their pro rata share of the credit losses on the trust's receivables with their pro rata share of finance charge collections and, in some cases, other revenues (such as fees or interchange).[3] This is accomplished through the cash application provisions of the master trust documents.

[3] For convenience, all revenues allocable to investors are referred to below as "finance charges" or "finance charge collections."

In some trusts (so called "capitalist trusts"), these applications are made solely (or initially) on a series-by-series basis. In others (so called "socialist trusts"), they are made on a shared basis among all outstanding series of investor certificates (or groups of outstanding series). In either case, on a monthly basis the investors' share of finance charge collections (determined using the floating allocation percentage) are applied to the following items:

- to pay an arms-length servicing fee to the selling bank, which continues to send out monthly statements, handle cardholder inquiries and otherwise service the trust's receivables;
- to pay interest to the investors at an agreed contractual rate; and
- to cover the investors' share of credit losses on the trust's receivables (determined using the floating allocation percentage).

Any excess remaining may be made available to cover similar items for other investor series or trapped in "spread accounts" or other cash accounts that provide credit enhancement for the investor certificates. Any excess remaining after these additional uses is ultimately paid to the selling bank, which gives rise to the interest only strip asset that many banks book under U.S. generally accepted accounting principles as a result of these transactions.

What does it mean that the investors' share of finance charge collections is used to "cover" the investors' share of credit losses? Essentially, it means that a portion of those collections (in an amount equal to the investors' share of the credit losses) is treated like principal collections. The finance charge collections take the place of the collections that should have been received on the charged off receivables, filling the asset gap created by the credit loss. If the revolving period for a series has ended, these converted collections are used to make principal payments to the investors or set aside to make such payments in the future, like actual principal collections allocated to the series. During the revolving period for a series, converted finance charge collections are generally paid to the selling bank as a reinvestment in new and outstanding principal receivables, again paralleling the treatment of investors' share of actual principal collections.

If the investors' share of finance charge collections are not sufficient to cover the investors' share of credit losses, then draws are made on any available credit enhancement, which typically take the form of cash collateral accounts and/or subordinated certificates. To the extent that any of these credit enhancements are provided by the selling bank, the bank is required to hold capital against the securitized receivables, subject to the low level recourse rule.

C. Early Amortization Provisions.

The fundamental measure of how well a credit card securitization (and the underlying portfolio) is performing is whether or not the investors' share of finance charge collections is sufficient to cover servicing fee, investor coupon and the investors'

share of credit losses. This is demonstrated by the fact that the only early amortization event in most credit card securitizations that relates to portfolio performance is the so-called "base rate test." That test compares

- the investors' share of finance charge collections, net of the investors' share of credit losses (such net number being commonly called "portfolio yield") to

- the sum of the investors' servicing fee and investor coupon (such sum being commonly called the "base rate").

If the portfolio yield is less than the base rate on average over three consecutive months, then the revolving period will terminate early and an early amortization or similar period will begin.

The other events that can cause an early amortization of a series are generally limited to bad acts by the selling bank (such as a material misrepresentation or breach of covenants) or events that threaten the legal integrity of the transaction, such as insolvency of the selling bank. These matters are generally either within the selling bank's control or so remote as not to present a material risk to the selling bank. As a result, in discussing the managed assets approach to credit card securitizations, we believe it is appropriate to focus almost exclusively on the base rate test.

II. Why the Managed Assets Approach is Inappropriate.

The discussion of the managed assets approach in the Consultative Paper is only five lines long—extraordinarily brief for such a sweeping and unprecedented change. As a result, we have only a very general indication of the Committee's reasons for making this proposal. Recently, however, the U.S. Federal banking regulators have published a notice of proposed rulemaking, 65 Federal Register 12320 (March 8, 2000), that includes a proposal to implement the managed assets approach in the U.S. prior to the conclusion of the Committee's deliberations. That proposal includes a somewhat lengthier explanation of the regulatory purposes of the managed assets approach. In responding to the managed assets proposal, we have assumed that the purposes identified in the U.S. proposal are consistent with the Committee's reasons for proposing the managed assets approach.[4]

Based upon the U.S. proposal, it appears that the managed assets approach is intended to address either a concern that early amortization features create some type of disguised recourse to the selling bank or that they create liquidity or other non-credit risks that justify an additional capital charge relating to these transactions. As discussed more fully below, we do not believe that these transactions involve credit or other risks that justify this extraordinary capital treatment.

[4] The Committee's February 2000 paper on "Sound Practices for Managing Liquidity in Banking Organizations" contains a brief discussion of early amortization features that mentions some of the same issues as the U.S. proposal.

A. Typical Early Amortization Features do not Constitute Credit Recourse.

Early amortization features are not designed to shift credit risk from investors to a bank that securitizes receivables. When rating agencies rate a series of master trust certificates, they set the required level of credit enhancement for each class of certificates based on the amount of credit losses to which the series may be exposed in a stress (*i.e.*, high loss) scenario over the period of time that they believe it might take to recoup the investors' investment in a stress (*i.e.*, slow payment speed) scenario. The rating agencies do not rely on the securitizing bank to cover losses. They require adequate structural credit enhancements to cover the investors' share of losses.

In the ordinary course, the parties to a credit card securitization do not expect any draws to be made on the credit enhancement. It is generally expected that investors' share of finance charge collections will be adequate to cover servicing fees, investor coupon and the investors' share of credit losses. As a result, credit enhancement is not sized to provide any protection during the revolving period, which often lasts from two to four years and sometimes is substantially longer. Credit enhancement is sized to cover loss exposure over the period that it takes to repay investors, if portfolio performance deteriorates to the point where material draws are made on the credit enhancement. The purpose of an early amortization feature, from the rating agencies' point of view, is to detect a significant deterioration in portfolio performance and start the pay out process before a material portion of the credit enhancement is used up.

Given these structural facts, there is no need for the Committee to impose an additional charge for credit risks relating to securitizations with early amortization features. The investors' share of the credit risks relating to existing receivables in these transactions is covered through the credit enhancement structure embedded in the securitization. If the selling bank provides any of those credit enhancements, then its share of the risks is already covered through what usually amounts to dollar for dollar capital on the amount of the exposure, under the low-level recourse rule.

The U.S. proposal relating to the managed assets approach states: "The early amortization feature ensures that investors will be repaid before being subject to any risk of significant credit losses."[5] We respectfully submit that this is not correct. The base rate test, which is the key event that might start an early amortization, is tripped at roughly the point when credit enhancement draws start to be made, meaning that the protection for at least the most junior level of investor certificates is being eroded. Although the credit enhancement is set at a size that is expected to last through the pay down period, it is always limited in amount. There is always a possibility that it will be exhausted, in which case investors would bear directly their share of the losses on the portfolio.

Importantly, the credit enhancement generally takes one or more of the following forms:

[5] 65 Fed. Reg. 12330.

- subordinated classes that are held by parties other than the selling bank and its affiliates; or

- spread accounts, which are funded either from the investors' share of finance charge collections (before an absolute short fall arises) or from initial deposits by the selling bank (or both).

Subordinated classes held by unaffiliated third parties do not impose any risk of credit loss on the selling bank. To the extent that spread accounts are reflected as assets on the selling bank's balance sheet, banks are already required to hold dollar for dollar capital against them under the low-level recourse rule.

B. Liquidity Issues do not justify the Managed Assets Approach.

The U.S. proposal also refers to liquidity problems that an early amortization can create for a seller.[6] It is true that loss of funding from a master trust would require a securitizing bank to seek other funding sources or to pursue other business options. However, this type of liquidity planning and contingency management has not conventionally been dealt with through the risk-based capital framework, and we do not think the risk-based capital framework is the appropriate way to handle this issue.

In this connection, it is worth noting that credit card issuers generally have the contractual right to reduce or terminate credit lines. As a result, this line of business is one that provides banks with more than one way of responding to a loss of funding availability for its credit card program. There is also an active market for the purchase of portfolios of credit card accounts, which provides another exit scenario and potential liquidity source for issuers.

Any well-run bank has to plan for possible shifts in availability of its funding sources. In banking organizations with substantial reliance upon master trust funding, the applicable bank supervisor may wish to review these contingency plans as a safety and soundness matter. In many or most cases, we believe that the banking organization will be able to demonstrate to its supervisor that it has adequate alternatives available to it and that no incremental capital charge relating to the managed securitized assets is necessary. As a result, we do not think it would be appropriate to automatically impose a capital charge on managed assets whenever a bank uses a securitization structure with an early amortization feature.

Another factor that a bank considers in liquidity planning is how high is the probability that an early amortization event will occur. Before executing a revolving securitization with an early amortization feature, a bank will look at a variety of stress tests to determine how much the performance of the portfolio would have to deteriorate in order for it to fail the base rate test and start an early amortization. A prudent bank generally will not complete the transaction unless it is highly confident that this will not

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[6] 65 Fed. Reg. 12330.

occur. The historical record indicates that banks as a whole have done very well at this analysis, as the number of early amortizations that have occurred is very small, especially as a percentage of the numerous transactions that have been completed. Although we are aware that some institutions may have taken actions to avoid early amortizations that the Committee might view as "implicit recourse," the number of those situations has also been small as a percentage of the overall issuance volume.

The Consultative Paper seems to have recognized that the managed assets capital charge might be an extraordinary step to take when justified by particular circumstances. The Consultative Paper says that the capital charge on managed assets would apply "when, in the opinion of the supervisor, uncontrolled early amortization or master trust agreements may pose special problems to the originating bank." However, the later U.S. proposal has taken a different stance, proposing to apply a managed assets approach to all bank securitization transactions that incorporate early amortization provisions.[7] We do not know whether this difference in the U.S. approach reflects a particular national stance or an evolution in thinking that may be shared by the Committee.

C. Implicit Recourse Should Not be Presumed in Master Trust Transactions.

The U.S. proposal also suggests that the two perceived risks discussed above "can create an incentive for the seller to provide implicit recourse—credit enhancement beyond any pre-existing contractual obligation—to prevent early amortization."[8] Although we are aware that some institutions may have chosen to provide additional enhancement in particular circumstances, we object to what would effectively be a regulatory presumption that implicit recourse would be provided. A bank confronted with deterioration in a securitized portfolio of credit card receivables has a number of options to consider, such as repricing or adjusting credit limits. It is by no means certain that providing additional recourse is the option that would always be selected. In addition, bank regulators currently have the authority to increase capital requirements or take other actions when a bank provides implicit recourse. We believe that these existing regulatory powers are adequate to deal with this issue on a case by case basis. An individualized approach where implicit recourse has been provided is more appropriate than a blanket presumption that it will be provided.

D. Pricing and Credit Availability would be Negatively Affected by the Proposal.

We believe that current capital rules require banks to hold more than enough capital in connection with securitized credit card portfolios. An increase in required capital is likely to either increase the cost of credit to consumers or impair the profitability of issuing banks as banks either pass on the cost of additional capital to consumers or are unable to fully do so. It is also likely to reduce the availability of this form of credit. Some banks may not be willing to commit the full amount of capital

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[7] 65 Fed. Reg. 12330-31.

[8] 65 Fed. Reg. 12330.

necessary to maintain their current or projected portfolios, and competition of new entrants is likely to be reduced if the capital required for the business exceeds what is economically necessary.

E. Disclosure of Early Amortization Risks.

The U.S. proposal acknowledged that "there may be concerns that the managed assets approach may not produce safety and soundness benefits commensurate with the additional regulatory burden that would result from a 20% risk weight on managed assets."[9] As a result, the U.S. bank proposal requests comment on possible alternative measures that would address more effectively the risks arising from early amortization provisions in revolving securitizations, including greater public disclosure of securitization performance.

We agree that disclosure is a more suitable approach to this issue, but we question whether any additional disclosure is needed. Most banks that securitize credit card receivables using master trusts are contractually required to provide information to investors on a monthly basis that includes, among other things, a calculation of the base rate test, or information sufficient to permit an investor to make that calculation. As stated above, the base rate test is the key measure that the market uses to assess the performance of these transactions, and it ties directly into the key early amortization event in these transactions. We believe that this existing disclosure, combined with case by case supervisory discussions of liquidity and contingency planning, represents an adequate and appropriate regulatory approach to the issues created by early amortization features.

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Respectfully submitted.

[9] 65 Fed. Reg. 12331.

Schedule I

Commenting Banks*

America's Community Bankers
Bear, Stearns & Co. Inc.
Capital One Financial Corporation
Charming Shoppes, Inc.
The Chase Manhattan Corporation
Deutsche Bank Securities Inc.
First USA Bank, N.A. (subsidiary of BANK ONE CORPORATION)
Fleet Credit Card Services
MBNA America Bank, N.A.
Metris Companies, Inc
Morgan Stanley Dean Witter & Co.
People's Bank
Providian Financial Corporation
Salomon Smith Barney
Spirit of America National Bank
Wachovia Bank, N.A
World Financial Network National Bank

* With your permission, we expect to add to the list of Commenting Banks as more institutions obtain internal approval to support the positions set out above.