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Sir/Madam,

COMMENTS ON NEW BASEL CAPITAL ACCORD ("BASEL II")

In response to your invitation for comments on the draft Basel Capital Accord, we have pleasure in contributing what we hope are two constructive proposals to amend the draft.

Proposal 1

Basel II proposal should distinguish between banks acting as Sponsors of general purpose ABCP conduits from those acting as Repackagers of Securities.

We draw your attention to the UK's Financial Services Authority ("FSA")'s paper on Securitisation issued on 30 June 2000 which recognises the distinction between a Bank acting as a Repackager from one acting as a Sponsor.

As a Repackager a bank might buy investment grade securities issued by third parties from the market and on-sell it to a Special Purpose Vehicle ("SPV") which funds itself by issuing a combination of short, medium or long term securities. In this context, 'third parties' means parties other than the members of the bank's wider accounting group. Also, the securities issued by the SPV will very likely have different risk characteristics to the ones it bought from the Repackager.

A Bank acting as a Repackager has no special relationship with the issuers of third party financial instruments as it might do in its capacity as a Sponsor of say, a Trade Receivables ABCP Conduit which has been set up to refinance a customer's trade receivables. As a Sponsor, the

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bank might structure the receivables to make them eligible for refinancing via the ABCP Conduit in a way that could involve the bank accepting a certain amount of risk directly onto its balance sheet, typically via the liquidity facility, which, ABCP investors are not prepared to accept.

On the other hand a bank acting as a Repackager is looking to generate income by buying investment grade financial instruments at market prices and hoping to refinance them via an SPV at lower prices leaving a profit after including all SPV costs.

We would like the Basel Committee to distinguish between the roles of a bank acting as Repackager from one acting as an Originator or Sponsor. The importance of making this distinction is to do with the treatment for capital purposes of the First Loss Credit Enhancement. We would propose that any First Loss Credit enhancement facility held by a bank as Repackager should not be an automatic deduction from capital as is currently proposed for a bank acting as a Sponsor. Where the First Loss Credit Enhancement facility¹ in a Repackaging transaction is rated investment grade by a reputable external credit rating agency, then in the hands of the Repackager it should be treated as any other Asset Backed Security with an identical investment grade rating.

e.g. an Aa3 rated First Loss Credit Enhancement facility should attract a 20% credit conversion factor as any other Aa3 ABS investment.

Thus a \$100 Aa3 rated First Loss Credit Enhancement facility should require only \$1.6 of Capital ($\$100 \times 20\% \text{ ABS Risk Weighting} \times 8\% \text{ Capital}$) and not \$100 of capital as the current draft would suggest.

If the current draft is not amended along the lines we have suggested, an inconsistent situation could arise where a highly rated tradable ABS instrument is 20% weighted in the hands of one bank investor and 1,250% weighted in the hands of another bank if it happened to be the Repackager. In the circumstances, the Repackager will not be able to hold the security almost regardless of the spread the security pays. This would create an unnecessary market distortion since other banks knowing what the penalty would be for the Repackager were it to hold the highly rated instrument, will demand a far higher return than would

¹ Where the assets being repackaged are Asset Backed Securities, each such Security may have its own inherent credit enhancement and what may appear to be a First Loss Credit Enhancement Facility at the Repackaging SPV level will in fact be a Second Loss Credit Enhancement Facility.



be warranted by the level of credit risk in the security before agreeing to buy it.

Proposal 2

Basel II proposes that short term committed liquidity back up lines designed to cover short-term market disruptions should no longer have a credit conversion factor of zero but should be subject to a 20% credit conversion factor ("CCF") providing it is 'true' liquidity and is not credit enhancement disguised as a liquidity facility, in which case, it would be subject to a 100% credit conversion factor.

There is no explanation or rationale offered by the Committee as to why it has selected a CCF of 20%. Nor has the Committee taken account of the credit risk to the bank providing the liquidity in the event the line is drawn.

We would like to propose the following framework for calculating the amount of capital a bank should be required to hold if it provides committed backup liquidity lines to Commercial Paper funded Conduits to cover short-term market disruptions.

Our suggestion is that the use of capital should be a function of both the probability of the liquidity line being drawn AND the probability of credit default once drawn.

The concept of using probability to quantify credit risk and assess use of capital is nothing new to the Committee given the internal ratings-based approach it has advanced in the draft paper.

We further suggest that the probability of drawing should be represented by the CCF, and the probability of credit default once the line is drawn can be based on a rating of the liquidity line by an external rating agency, i.e. it can be based on an ABS Risk Weighting Factor.

We agree with the Committee's suggestion that a liquidity line that is not true liquidity and is disguised credit enhancement should carry a CCF of 100%; in other words indicating a higher probability that the line could be drawn even if there were no market disruption.

On the other hand if the line is true liquidity but the term of the commitment is more than one year, there is an increased probability that the line would be drawn and the CCF could be set at 50%.



If the line is true liquidity and the committed term is under one year, then the probability of the line being drawn, i.e. the CCF should, we suggest, be based on the documented amount of the drawn margin or spread to Euribor/Libor once the line is drawn.

From our experience as providers of liquidity to the Conduits we administer as well as to other Conduits, the higher the drawn margin of a liquidity facility, the greater the disincentive to drawing it even in times of 'minor' market disruptions, which, for example occurred in the second half of 1998 after the Russian crisis, and therefore the lower the probability of the line being drawn:

To summarise our proposal:

Capital Required =

- x Committed amount of liquidity facility
- x Credit Conversion Factor for Liquidity
- x Liquidity Line rating (ABS Risk Weighting Factor)
- x 8% Capital

Set out below is a table illustrating how capital required would vary depending upon the rating of \$100 of 1 year committed liquidity assuming a constant low probability of drawing equivalent to a CCF of 20%.

| <u>Aa3 Rating</u> | <u>Baa3 Rating</u> | <u>Ba1 Rating</u> |
|-------------------|--------------------|-------------------|
| \$100x20%x20%x8% | \$100x20%x100%x8% | \$100x20%x150%x8% |
| =\$0.32 | =\$1.6 | =\$2.40 |

We are aware that our proposal is not unique and has been echoed by a number of market participants including Moodys Investor Services in a recent paper dated April 20, 2001, titled "Entering A New Regulatory Environment: Proposed Revisions to the 1988 Basel Accord May Raise Costs and Squeeze Availability of ABCP Liquidity" and attached for your information.

The main difference between our proposal and the general proposal described in the attached Moodys paper is our suggestion that the CCF should range from 0% reflecting very low probability of a liquidity drawing to 100% for a high probability of a liquidity drawing.



If the Committee is prepared to accept the idea that the probability of drawing is directly related to the size of the drawn margin in assessing the CCF of a committed liquidity line, the follow up question is how in practice should it set minimum drawn margins and over what period of time in order to derive varying CCFs.

To answer this question we would suggest that both the US ABCP and the Euro ABCP Markets are sufficiently mature to obtain historic market data of the cost of CP funding of differently rated ABCP Programs during 'minor' market disruptions particularly during the second half of 1998. This data would establish 'high water marks' for extremes of cost of CP funding during market stress and in turn could be used to establish minimum levels of drawn margins for different CCFs and for a given rating of a Conduit's CP. For example:

- (a) for ABCP rated A-1+/P-1/F1+ it is highly unlikely that the cost of CP would ever exceed Libor/Euribor +0.20% per annum and remain at that level for a period exceeding 90 days
- (b) for ABCP rated A-1/P-1/F1 it is highly unlikely that the cost of CP would ever exceed Libor/Euribor +0.30% per annum and remain at that level for a period exceeding 90 days.

In the case of the US Asset Backed CP market the Federal Reserve Bank of New York collects data daily on funding levels by CP ratings via the DTC Clearing System and the above-mentioned 'high water marks' for cost of CP can be independently verified by the Basel Committee and used to set a floor on drawn margins for liquidity lines related to different CCFs,

i.e. the higher the minimum drawn margin of a liquidity facility, the lower the Credit Conversion Factor, and vice-versa.

Assuming the above-mentioned figures for 'high water marks' in the ABCP market are correct, then providing the drawn margin for a short-term liquidity facility is, say, twice the 'high water mark'

e.g. if the drawn margin in a standby liquidity facility provided to an A-1/P-1/F1 rated ABCP Program is set at no less than Libor/Euribor + 0.6% (2X0.30%),

the probability of drawing would be very low and we would propose the Credit Conversion Factor should be set at 0%. If the drawn margin is



set at the 'high water mark' of 0.3%, then the CCF should be set at 20% and if the drawn margin is set at below the 'high water mark' the CCF should be set at 100% to reflect the higher probability of a drawing.

Thus, if a liquidity facility of \$100 and under 1 year committed period is provided to an A-1/P-1/F1 rated CP Program and the facility itself is rated Aa3/AA- or better and the drawn margin is documented at Libor/Euribor + 0.6%, we propose that capital required,

$$\begin{aligned} &= \$100 \text{ (committed amount of facility)} \\ &\quad \times \text{Credit Conversion Factor (0\%)} \\ &\quad \times \text{ABS Risk Weighting Factor (20\%)} \\ &\quad \times 8\% \text{ Capital} \\ &= 0 \end{aligned}$$

It should be noted that since the issuer of the CP is an SPV, it would not get high ratings of A-1/P-1/F1 from the rating agencies unless it had the ability to withstand high cost of funds of Libor/Euribor +0.60% for the stipulated period of at least 3 months. In order for it to do so, the Sponsor of the ABCP Program would either have to inject resources into the SPV that would result in a 100% capital deduction or it would have to forego future profits which would remain undistributed in the SPV to build up reserves to withstand unfavourable market conditions for a prolonged period of time of at least 3 months.

However, for major market disruption, which, has so far not occurred, the liquidity facility would have to be drawn to repay maturing CP, which, could not be rolled over.

We hope our two proposals will be carefully considered when preparing the final draft of Basel II.

Yours sincerely,

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