25. May 2001

Baseler Ausschuß für Bankenaufsicht/Basel Committee on Banking Supervision
Bank für Internationalen Zahlungsausgleich/Bank for International Settlements
CH-4051 Basel
Schweiz

Re: The New Basel Capital Accord – Asset Securitisation Aspects of the Standardised Approach

Ladies and Gentlemen:

The European Securitisation Forum (the "*Forum*")[1] appreciates this opportunity to comment on the consultative proposals (the "*Consultative Proposals*") regarding the New Basel Capital Accord (the "*Accord*") released by the Basel Committee on Banking Supervision (the "*Committee*") in January of this year. This letter contains some of the Forum's comments on the asset securitisation proposals included in the Consultative Proposals. We anticipate submitting an additional letter in which we will comment on some portions of the securitisation proposals that were not fully developed in the Consultative Proposals, particularly the application of an internal ratings based approach ("*IRB*") to securitisation.[2]

The Forum supports the Committee's efforts to rework the capital adequacy framework to better reflect the relative risks of various assets. Given the important and growing role of securitisation as a funding source and liquidity and credit risk management tool for banks, it is important that the new Accord address securitisation in a systematic, well thought out and consistent way. While the Consultative Proposals are a good start, they also suggest some inappropriately strict requirements for securitisation and some unjustified incremental capital requirements for securitisation as opposed to other bank activities.

[1] The European Securitisation Forum is a European financial markets trade association sponsored by The Bond Market Association ("TBMA"). The Forum was established to promote the continued growth and development of securitisation and to advocate the positions and represent the interests of the securitisation market throughout Europe. The Forum has a diverse membership which includes banks, securities houses, issuers, investors, rating agencies, legal and accounting firms and other professional participants active in the European securitisation markets. More information about the Forum, including its purpose and mission, its full membership and its current projects and activities, can be obtained from its website at www.europeansecuritisation.com.

[2] In addition to these submissions by the Forum, TBMA (the US-based trade association representing banks and broker dealers active in the fixed-income securities markets, including the MBS and ABS markets) will be submitting separate comments on the securitisation-related aspects of the proposed new Basel Capital Accord. TBMA's comments, although developed separately by its membership, are materially consistent with those provided by the Forum herein.

Despite the significant progress represented by the Consultative Proposals, the Forum is highly concerned that the current December deadline actually threatens to hinder the finalisation of workable capital regulations for asset securitisations. This artificial deadline is causing very complex matters to be handled with too much haste. It does not provide enough time for the Committee and staff to review, consider and incorporate, as applicable, insights, helpful data and formal comments submitted on the Consultative Proposals. With outstandings of asset-backed securities now in the trillions of Euro globally, the danger is too great that hastily issued and imperfect or even flawed rules could materially damage an industry that is a demonstrably safe and important operating business for banks.

We believe that another draft should be circulated for formal comment prior to issuing final rules. We believe that the December deadline must be set aside and that the Committee and staff need to develop a more realistic time table for publishing a fully developed proposal, permitting thoughtful analysis and input from industry participants, and adopting and implementing nationally workable final rules.

EXECUTIVE SUMMARY

The Forum's principal comments on the asset securitisation aspects of the standardised approach included in the Consultative Proposals are set forth below:

Originating Banks (see Part 2 below)

- The treatment of credit enhancements and other securitisation positions should depend on the risk of a particular position rather than on who holds it.
- Transferors should not be required automatically to deduct from capital the amount of retained interests in excess of the amount of on-balance sheet capital required for the underlying assets.
- The managed assets approach for revolving structures contains distorting elements that should be eliminated or modified.
- The clean break requirements would benefit from a number of technical changes and clarifications.

Investing Banks (see Part 3 below)

- The Forum strongly supports both the external ratings based approach for rated positions and the look-through approach for unrated positions.
- Risk-based capital requirements based upon external credit ratings should incorporate finer gradations between and among categories so that capital requirements better reflect actual differences in credit risk.

- At many ratings levels, the risk weights for securitisation positions should be lower than those proposed by the Committee. At a minimum, the risk weight for securitisation positions at a given rating level should never be higher than the risk weight for an identically rated conventional corporate exposure.

Sponsoring Banks (see Part 4 below)

- The Accord should confirm that sponsor-provided programme level support does not count as a "first loss" position (but rather as a second loss or more senior position, as appropriate) where seller-provided or other transaction level credit enhancement exists.

- The Accord should continue the use of a credit conversion factor and risk weight in calculating required capital for liquidity commitments.

- The conversion factor for liquidity commitments of one year or less should not exceed 10%.

- Further draw limitations on liquidity commitments would be inappropriate.

- The proposed disclosure requirements when applied to multi-seller ABCP programmes ("*Multi-Seller Conduits*") and sponsor banks should be significantly pared back.

Synthetic Securitisations (see Part 5 below)

- The treatment of first loss positions in synthetic securitisations (regardless of their format) should follow the treatment accorded to traditional securitisations.

- There should not be any threshold level of risk transference or a restriction on the size of the first loss position, as the deduction from capital approach adequately addresses these issues.

- A 0% capital charge should be assigned to the originating institution for exposure evidenced by mezzanine risk notes that are sold to third parties, when cash or highly-rated eligible collateral is held in an SPV for the benefit of the originating/beneficiary institution.

- The implied credit quality of the senior rated risk position in synthetic securitisation transactions should be recognised, whether or not a swap covering the so-called "super-senior" position has been entered into.

Generally (see Parts 6 and 7 below)

- The Forum strongly opposes the assessment of an additional *ex ante* capital charge to address implicit and residual risks arising from securitisations.

- We and other concerned parties should be given a chance to comment on another draft of all of the Consultative Proposals with regard to securitisation before they are finalised.

- An adequate transition period should be provided once the final Accord has been adopted within any particular country.

COMMENTS

1. Securitisation Market Background

As the Committee itself recognises, securitisation can serve as an efficient means of redistributing a bank's credit risk to other banks and non-bank investors.[3] The Forum agrees, and believes that securitisation has also proven its value as an efficient funding and capital management mechanism. By providing an effective means for banks to redistribute their market risks to investors and the broader capital markets, securitisation facilitates prudent risk management and diversification. Finally, as supported by the discussion and data set forth in the body of this letter, securitisation has proven itself to be a source of safe, fixed income assets from the perspective of banks as investors.

Securitisation transactions structured as sales subject bank assets to market scrutiny and can allow reductions in required capital when regulatory levels are proven to be overly conservative. However, securitisation is also frequently a more efficient and flexible financing option in comparison with others available to banks. For example, the ability of a bank issuer to subdivide and redirect cash flows from underlying assets among a range of sold and retained interests can provide it with both cheaper funding and the ability to achieve a more precise matching of the duration of its managed assets and liabilities.

From a broader economic and systemic perspective, the existence of efficient securitisation markets has increased the availability, and reduced the cost, of financing in the primary lending markets. Efficient securitisation markets serve to reduce disparities in the availability and cost of credit by linking local credit extension activities to a broader capital market system. As a result of that linkage, securitisation subjects the credit extension functions of individual financial institutions to the pricing and valuation discipline of the capital markets. The securitisation process thus promotes the efficient allocation of capital and management of risk within those institutions while serving to mitigate systemic risk throughout the financial system as a whole. In turn, borrowers and other recipients of credit benefit directly from its increased supply and lower cost.

In view of these important micro- and macro-economic benefits, the Forum regards it as critically important for regulatory capital regulations to avoid imposing unnecessary

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[3] See paragraph 14 of the *Overview of the New Basel Capital Accord* included in the Consultative Proposals.

restrictions on the ability of banks to benefit from the application of securitisation techniques to fund their lending operations efficiently.

The Forum's members are active in a wide range of asset securitisation activities. As securitisation issuers, dealers and investors, bank members of the Forum would be directly subject to the new Accord. As providers of investment banking, securities underwriting, distribution, trading, capital markets services and other services to banks and other financial institutions that are engaged in asset securitisation activities, the Forum's non-bank members would also be impacted by these proposals. Both categories of the Forum's membership thus have fundamental interests in preserving an adequate safety and soundness cushion for regulated institutions, while simultaneously promoting economically efficient securitisation markets.

2. Treatment of Originating Banks

2.1. Clean Break Criteria[4]

The Forum agrees that a bank should have to meet minimum criteria to remove securitised assets from its risk-based capital calculation, and the Committee's proposed clean break criteria generally address the right types of considerations. However, the Forum has some important technical comments relating to the proposed criteria.

a. True Sale

First, the introductory language to paragraph 518 of the Consultative Document requires a "true sale." We recommend that the Committee avoid using that phrase and rely instead on the essential requirement of *legal isolation* already contained in subparagraph 518(a) of the Consultative Document. The phrase "true sale" has a very specific legal meaning and is not appropriate in all circumstances. Methods of transferring assets vary greatly from country to country, and there are a wide variety of such methods which achieve the legal isolation required by subparagraph 518(a) of the Consultative Document but involve circumstances where counsel would not necessarily be able to render a "true sale" opinion.[5] The Committee should recognise these differences between legal rules and confirm that transfers of assets achieving legal isolation from the transferor, supported by a legal opinion, meet the clean break criteria whether or not the transfer constitutes a true sale.

b. Qualifying Special Purpose Entities and Transfer Restrictions

Second, subparagraph 518(b) of the Consultative Document requires that the transferee be a "qualifying" special-purpose vehicle, which a footnote to paragraph 13 of the Consultative

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[4] Paragraph 518 of the main Consultative Document (the "*Consultative Document*").

[5] One example of such a transfer is the sale of the risks and benefits of a loan by way of a funded sub-participation under English law.

Document on Asset Securitisation (the "*Securitisation Paper*") indicates will be "defined by national accounting standards." We strongly oppose any such whole-sale incorporation of accounting standards into the Accord, as the objectives of the Accord and of national accounting standards differ significantly. We also strongly oppose any requirement that the transferee *must* be a qualifying special-purpose entity ("*QSPE*") in order to satisfy the clean break criteria, so long as the transfer has achieved the legal isolation of the assets required by subparagraph 518(a).

Provided that a transfer achieves the legal isolation of the assets being transferred, the nature of the transferee should not matter. In practice, many securitisation transferees are not QSPEs, but the transferred assets are nevertheless legally isolated from the transferor. Multi-Seller Conduits are an important example, as they generally do not qualify as QSPEs.

Accordingly, we request that the Committee delete subparagraph 518(b) and rely instead on the requirement of legal isolation already contained in subparagraph 518(a).

If the Committee thinks it necessary to permit (but for the reasons provided above not mandate) the use of qualifying special purpose entities and to provide a definition for them, we recommend a uniform definition in the Accord itself which is much more general. Defining qualifying special purpose vehicles by reference to national rules opens the door to inconsistent standards, creates incentives to engage in regulatory arbitrage (via cross-border transactions structured to sell assets into favourable jurisdictions) and, ultimately, leads to confusion about which rules should apply to certain transfers and inconsistent results. An acceptable definition for special purpose transferees of assets in securitisation transactions is the one used for "issuer" set out on Attachment A to this letter.

c. Clean-up Calls

The Forum supports continuation of the rule permitting clean-up calls for up to 10% of an asset pool, and believes that the final Accord should specify that clean-up calls under this threshold do not require prior consultation with national supervisors in order to be consistent with the clean break criteria.

d. Additional Clean Break Requirements

Finally, we note that the "clean break" requirements in the Consultative Document 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 Document. The specified requirements are sufficient effectively to achieve the legal isolation of 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 simply to cross-reference other requirements of the Accord—to indicate for example that even if a bank met the 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 explicitly to refer to those other sections rather than imply that additional operational requirements could be added to those articulated.

2.2. Minimum Capital Requirements for Credit Enhancements[6]

a. Neutral Treatment of Second Loss Positions

The Forum's primary concern with this portion of the Consultative Proposals is that it continues to treat different banks holding similar positions differently. In particular, paragraph 521 of the Consultative Document states that in order for a second loss credit enhancement 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 securitisation of €100 million of instalment 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 standardised external ratings based approach in the Consultative Proposals, 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 imposes distorting financial burdens on originating banks—they must either retain second loss positions and hold capital against them which is disproportionately large relative to the capital held by third party purchasers of the same assets, or sell the second loss positions into a market which knows that the originators have unique costs if they hold onto the retained loss positions, or abandon the securitisation transaction altogether.

In addition, 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

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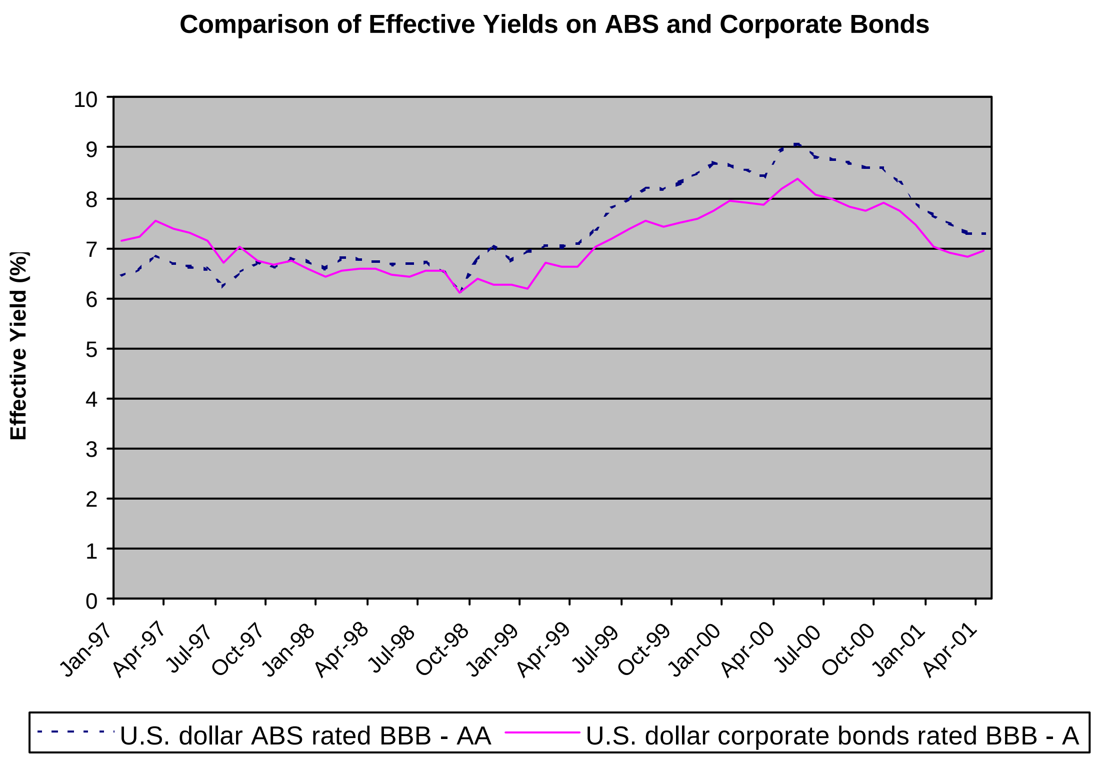
[6] Paragraphs 520-522 of the Consultative Document.

market coupon that is higher than the originator's on-book cost of funds. This incentive exists under the current rules and has a significant observable effect on banks' issuing activity. Specifically, most banks that issue asset-backed securities sell subordinated tranches rated down to BBB (or even BB) or its equivalent, in order to avoid the excessive capital charges that would result if they retained those tranches. This issuance pattern is common even where the issuing banks have unsecured investment grade ratings and could generally raise funds on balance sheet at a lower cost than the coupon on BBB or A category tranches.



The chart above[7] compares the effective yields for U.S. dollar ABS rated between BBB and AA, on the one hand, and U.S. dollar corporate bonds of issuers rated between BBB and A. As shown, and despite including in the ABS category AA-rated securities (which lowers the average yield), the ABS category has generally had a higher yield than the corporate category since October 1997. This data demonstrates that for banks rated BBB and above, ABS tranches rated BBB to A have generally not provided the most attractive funding cost, at least over that time period. That banks have continued to generally sell those tranches is attributable largely to the excessive capital costs associated with retaining them.

[7] Source: Merrill Lynch Global Bond Indices, as found on Bloomberg.

As the Committee moves towards its commendable goal of more closely aligning regulatory capital requirements with risk, these types of artificial distinctions and the distortions they create should be eliminated. The capital requirement under the standardised approach for securitisation positions bearing similar risks 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. It also should apply under IRB for banks that qualify to use them.

In addition, 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 example, if a bank has issued two series of floating rate securities out of a revolving master credit card structure, 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 issuer, proportional interests in the exact same receivables support each series. As a result of the identical enhancement structure, the originator should clearly be able to impute the BBB rating received on the first Class C to the second unrated Class C. This imputation should also be permitted if there are separate asset pools (for instance in two separate securitisations of instalment loans) where the originator reasonably determines (subject to regulatory oversight) that the asset quality is substantially the same and the enhancement structure required by the rating agencies supports that belief.

b. Limiting Incremental Capital on First Loss Positions

The Forum believes strongly that, regardless of the size of an originator's retained interests in securitised assets, the originator should not be required to hold more capital with respect to those assets than the amount of capital that would be required if the underlying assets were held on the originator's balance sheet. Although the Consultative Proposals do not discuss the point at length, it appears that the Committee agrees. Specifically, paragraph 520 of the Consultative Document states that "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 italicised 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."

The Forum would strongly oppose any reading of the Consultative Document to the effect that an originating bank securitising assets and retaining a first loss position larger than the on-balance sheet capital requirement could be required to hold more capital post-securitisation than it held prior to the securitisation. Such an interpretation would result in

unduly penal and distortive capital requirements to be imposed on residual interests retained in securitisation transactions.

Specifically, the Forum believes—based upon the direct experience of many of our bank members—that most regulated financial institutions who are significantly engaged in asset securitisation activities have established and effectively carry out appropriate policies and procedures for valuing retained residual interests and managing liquidity, concentration and other related risks. The Forum believes that an interpretation resulting in increased capital would represent an overreaction to regulatory concerns precipitated by perceived deficiencies within a limited number of smaller, less sophisticated and less vigilant institutions and concerns about the credit quality of specific categories of underlying assets (for example, so-called "subprime" residential mortgages).

The Forum believes that a narrower and more targeted response is appropriate, rather than regulating to the "lowest common denominator." Instead of imposing full deductibility from capital for all retained residual interests, we recommend that national supervisors rely on their existing authority, as further clarified in the current proposals, to act on a case-by-case basis to impose additional operational requirements on specific institutions or additional capital requirements on specific instruments or underlying asset classes. In this way, we believe that exceptional capital requirements would be imposed only where they are warranted by the risk management capabilities of a particular institution or the risk profile of a particular instrument or underlying asset.

The fact that a bank has retained a residual interest in a securitisation transaction does not necessarily mean that the instrument or the assets that underlie it are exceptionally risky. Neither does it suggest that the bank is unable accurately to assign a value to the interest, or to sell it to an investor should it choose to do so. Instead, the economic characteristics of a residual interest and the decision to retain it on balance sheet are often driven principally by cost-of-funds considerations peculiar to the institution and individual securitisation transaction. Accordingly, the retention of a residual interest should not in all circumstances signify the need for additional regulatory capital beyond what would otherwise be required under the Consultative Proposals.

A requirement to deduct a residual interest fully from capital would be particularly inappropriate where that interest would qualify for more favourable risk-based capital treatment pursuant to the external ratings based approach or a qualified IRB. We believe that banks should be allowed to use external ratings and, where an institution can demonstrate the integrity of the criteria and procedures used, internal ratings to qualify residual and other retained securitisation interests for more favourable risk-based capital treatment.

If, notwithstanding the Forum's understanding, the Committee nevertheless applies new capital requirements to retained residual interests (whether any such new rules are applied only to individual institutions based on the exercise of supervisory discretion, as the Forum would prefer, or more universally), we believe that any additional capital requirement that is imposed should be limited to the amount needed to address any increased credit risk exposure

occasioned by the securitisation transaction, in comparison with the amount of capital that would have been required had the assets remained on an organisation's balance sheet.

In such circumstances, the Forum would endorse an approach providing that the required regulatory capital relating to a residual interest would not exceed the sum of (a) the amount of capital that would be required if the transferred assets remained on balance sheet, and (b) the incremental amount of capital that relates to the new assets, if any, on the originating bank's balance sheet resulting from the transaction. The Forum believes that this formulation would isolate reasonably the source of any incremental credit risk associated with a securitisation and would avoid the creation of inappropriate economic disincentives to the amount and type of funding that bank issuers may choose to raise via securitisation transactions, as part of their overall funding strategy.

c. Capital Treatment of Servicer Advances

The Forum believes that the proposal to require capital against servicing advance obligations would frequently result in excessive capital, and we oppose that proposal. At least two categories of servicer advance obligations should be excluded from any new capital requirement.

First, in some transactions, 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. Significantly, 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 cancellable, 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 cancellable and therefore should have a credit conversion factor (and resulting capital requirement) of zero.

2.3. Minimum Capital Requirements for Revolving Securitisations with Early Amortisation Features

The Forum opposes the proposed "managed assets" approach to revolving securitisation transactions that incorporate early amortisation provisions for several reasons. In our view, early amortisation provisions (which are a standard feature in credit card and certain other revolving securitisation transactions) represent a form of liquidity protection for bondholders, rather than constituting credit recourse to the banking organisation that sponsors the securitisation transaction. The provision of such liquidity advances neither renders the transferred assets more risky nor modifies the then-existing obligations (if any) of the

originator with respect to recourse. As such, we believe that any additional regulatory capital required pursuant to the managed assets approach would duplicate capital requirements already imposed on such sponsoring organisations for sale of assets with recourse.

Moreover, the specific terms and conditions of early amortisation and similar liquidity provisions vary among transactions, and may have different repayment priorities, structural features and operational characteristics. As a consequence, we do not believe that the imposition of a uniform capital treatment for all such provisions would be appropriate without a case-by-case examination of these differences. In fact, depending on asset type (*e.g.*, term and mortgage loans), the Committee's proposal may result in a duplicative imposition of capital. Revolving transactions already impose an implicit additional capital charge to cover that additional uncertainty, as credit enhancement levels (as a proxy for capital) are generally greater for revolving transactions than for amortising transactions based on the same initial pool. For synthetic transactions that do not use excess spread for credit enhancement, the additional capital effect can be more extreme.

In addition, current levels of disclosure and supervisory practices make unnecessary the proposed imposition of a uniform 10 or 20 percent risk weight in dealing with any special risks or contingencies posed by early amortisation features. Banks that securitise credit card receivables in revolving structures are required, both by the governing documents for those transactions and by established market custom and practice, to provide monthly information to investors, rating agencies and other market participants that explicitly addresses factors bearing on early amortisation risk. These data also constitute an appropriate base of information for use by banking regulators in supervising individual sponsoring organisations' management of early amortisation risks and related contingencies. The Forum believes that these disclosure and supervisory practices are adequately supported by the current level of information that is generated and made available by bank sponsors with respect to early amortisation provisions, and that the continuation of such practices is preferable to instituting a new capital charge against "managed assets."

Finally, we would request that the Committee clarify that its concerns relate solely to revolving credits (*i.e.*, assets where there is an ongoing obligation to fund) rather than revolving structures (*i.e.*, where sales of assets by the originator to the issuer take place more than once, typically monthly or quarterly). Revolving structures may of course be comprised of either revolving credits or term credits. Judging from the issues raised in paragraph 20 of the Securitisation Paper, it appears that the Committee is concerned with revolving credits; however, the draft Accord would benefit from an explicit statement to that effect.

3. Treatment of Investing Banks

3.1. Rated ABS[8]

The Forum strongly supports a ratings based approach for securitisation positions. This is an important step forward in matching regulatory capital requirements to the true risk of assets. The Forum advocates more gradients in the risk weighting grid and lower risk weights for some of the gradients included in the Consultative Proposals. However, even without those 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. We expect to submit additional materials to the Committee that will detail and support our suggested gradients.

At a minimum, the risk weight for securitisation positions at a given rating level should never be higher than the risk weight for an identically rated conventional corporate exposure. In fact, the Forum believes that, because both PD and LGD may actually be lower for securitisation positions at a given rating level due to structural and other factors, less capital may be appropriate for securitisation positions than for general corporate positions at the same rating level. We discuss below some of the reasons for our belief, and anticipate providing additional support for these views in our supplemental comment.

In this connection, the Forum notes that the 150% risk weight for securitisation positions begins at a higher rating level (BB+) than the corresponding risk weight for corporate exposures (BB-), and the Forum strongly opposes that discrimination against securitisation positions. The Consultative Proposals do not explain this difference, but we understand from discussions with staff that it may arise from a concern about the presence of greater systemic risk in securitisation positions. For a number of reasons, the Forum does not believe that this is correct.

- First, securitisation positions are stronger structurally due to the legal isolation of the assets from the risks of the transaction's various participants, effectively providing every securitisation position with collateral security to support its repayment. General corporate exposures, on the other hand, do not benefit from this legal isolation, are often not secured, and are more subject to general mismanagement and judgmental errors by officers and directors and other general corporate "event risks."

- Second, securitisation positions benefit from significantly greater pool diversity:

    - A large portion of securitisation positions relate to retail (consumer) assets, such as residential mortgages, credit card receivables and auto loans. The Committee has acknowledged that "By its very nature, retail business is highly unlikely ever

[8] Paragraphs 525-526 of the Consultative Document.

to worsen the granularity of a bank portfolio."[9] In light of this accurate insight, the Forum does not see how there could be any basis for suspecting greater systemic risk in a retail securitisation position than in a single corporate exposure.

- Even for ABS where the underlying assets are wholesale corporate exposures, the ABS position will by definition represent an interest in a pool that has structurally-imposed diversification (by sector and by obligor, for example), unlike a single corporate exposure.

- Third, securitisation positions benefit from layers of credit enhancement not found in general corporate exposures. Diversification requirements and layers of credit enhancements are two methods adopted in securitisation transactions to address risks, including the risk that similarity in pool assets can lead to "loss correlation". Such features are not found in single corporate exposures.

- Finally, available empirical evidence certainly does not support higher risk weights in connection with securitisation positions with a given rating than for conventional corporate exposures with the same rating.[10]

Recently available data from the rating agencies show that, rather than containing greater systemic or idiosyncratic risks, overall risk in asset securitisations is less than in corporate securities. For example, consider the following:

- Moody's shows no defaults for ABS in its historical database from 1985 to the present, regardless of rating.

- S&P shows a single investment grade default, but this was the result of fraud.

- S&P shows some BB defaults but at a rate approximately ½ that of corporate BB exposures. S&P shows no defaults at the B level.

- Investment grade ABS transactions show approximately the downgrade risk of corporate transactions over a five-year timeframe, and sub-investment grade transactions show approximately 80% of the corresponding corporate downgrade risk.

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[9] Paragraph 427 of the *Consultative Document* on *The Internal Ratings based Approach*.

[10] See *Structured Finance Default Study*, Structured Finance Special Report, Fitch IBCA, Duff & Phelps, January 8, 2001 (the average annual default rate of U.S. ABS securities was 0.01% of the original principal balance of such securities, compared with an average annual default rate for U.S. corporate bonds of 0.77%); and see *Rating Changes in the U.S. Asset-Backed Securities Market: First-Ever Transition Matrix Indicates Rating Stability…To Date,* Structured Finance Special Report, Moody's Investors Service, January 19, 2001 (according to such report, asset-backed security ratings have experienced lower transition rates than corporate ratings since 1986).

We urge the Committee to reconsider its risk-weights in light of the highly positive experience in the asset securitisation market.

Finally, for positions rated below BB- and for un-rated positions, the Forum accepts that significantly higher capital is justified under the standardised approach. However, any risk weight that is applied should not result in capital requirements that exceed the required capital if the underlying assets were held on balance sheet, subject to the possible need to hold capital against newly created assets as discussed in part 2.2(b) above.

3.2. Unrated ABS[11]

The Forum commends the Committee for including in the Consultative Proposals the look-through approach for unrated securitisation positions. The look-through approach is an elegant and prudent way of evaluating these positions. We suggest below a few refinements or clarifications.

The last sentence of subparagraph 527(a) requires that "In the case of an indirect claim, all liabilities of the trust or special purpose vehicle (or conduit) that issues the securities are related to the issued securities". While it is correct that the special purpose entities involved in this type of transaction have limited activities and liabilities, there should be flexibility for some practical exceptions to what appears to be an absolute prohibition on "unrelated" liabilities. The appropriate way to phrase this requirement (borrowing generally from rating agency requirements) would be that all parties entering into contracts with the SPE (other than the holders of the most senior asset-backed securities it issues) are required to promise not to file an involuntary bankruptcy petition against the SPE and that all parties with a contractual interest in the cash flows from the receivables are required to agree to an order of application of cash flows.

Subparagraph 527(b) says that the underlying assets "must be fully performing when the securities are issued." The Forum is not certain what the Committee means by "fully performing," but we are concerned that this standard is unrealistically strict. Even securitisations of liquidating pools of receivables generally permit some portion of the receivables to be delinquent up to some specified limit (such as 90 days) at the time of closing. In revolving and multi-seller structures, this cannot be avoided. Even if there were no delinquencies at the time of first issuance, there will always be some at the time of any subsequent issuance. If this subparagraph is retained, it should be revised to provide flexibility to handle these types of situations. We do not, however, believe that numerical limits should be specified, as it will be very difficult to specify limits that will be appropriate in all circumstances. We suggest instead that this subparagraph be deleted as a specific requirement and that supervisory discretion be used to handle any transactions with inappropriate levels of non-performing assets.

[11] Paragraphs 527-529 of the Consultative Document.

In addition, paragraph 529 says that if the underlying assets have varying risk weights, then the look-through approach will assign the senior securitisation position to the highest of those underlying risk weights. We believe it would be more appropriate to assign the senior securitisation position a risk weight that equals the weighted average of the underlying risk weights. That would be the result if the investing bank held the underlying receivables directly, and we do not see why the result should be different under the look-through approach for senior securitisation positions.

The Forum would agree that the Committee should limit the use of the look-through approach to situations where no rating has been sought for the position, as opposed to situations where an external rating was applied for but not given due to credit risk.

4. Treatment of Sponsoring Banks

4.1. Comments on Proposed Treatment of Credit Enhancement

a. Treatment of Second Loss Programme Enhancements that are not Externally Rated

The Forum thanks the Committee for including an approach for calculating the applicable risk weight for programme credit enhancement by reference to the related underlying asset pools. We continue to believe that a full IRB is an appropriate and preferred method for establishing minimum capital levels.[12] However, the approach that the Committee has proposed appropriately recognises the substantial first loss protections enjoyed by most programme credit enhancements and provides an acceptable interim alternative to an IRB for these exposures, subject to the following comments.

The approach proposed by the Committee may require a two-step look-through process:

- the risk weight of the second loss credit enhancement is determined by looking through to the underlying assets (we call this the "*programme level look-through*"); and

- often those underlying assets will be unrated securitisation positions, and their risk weights may (depending upon the Committee's reflection of our comments in the final Accord) be determined using the general look through treatment that the Committee has proposed for unrated positions (we call this the "*transaction level look-through*").

We have comments about both of these look-through steps. These comments will be easier to communicate with the aid of an example. Please assume that a new Multi-Seller Conduit has just two transactions:

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[12] While we believe that the Committee's intent to permit an IRB for assigning risk weights to unrated programme credit enhancement positions is implicit in the specifics of the January proposal, we note that the discussion of IRB in the Securitisation Paper does not specifically mention banks in their role as programme credit enhancement providers. We believe the final Accord should make this point clear.

- The first transaction is a €90 million senior interest in a €100 million pool of business-to-business trade receivables (with corporate obligors). The remaining €10 million is a first loss subordinated position retained by the conduit's customer.

- The second transaction is a €90 million A-rated Class B asset-backed security which was issued as part of a series that included Class C securities that are subordinated to the Class B security and the Class A securities that are senior to the Class B security.

- The conduit's sponsor provides a programme level letter of credit that can be drawn upon to support such conduit's ABCP if losses on any of the conduit's transactions exceed the applicable first loss protections. In the case of the first transaction described above, the programme letter of credit would be drawn upon to support such conduit's ABCP if losses on the underlying pool exceeded €10 million. In the case of the second transaction, the programme letter of credit would be drawn upon to support such conduit's ABCP if losses on the underlying pool exceeded the amount of the subordinated Class C securities (and any other amounts available to cover losses before impairment of the Class B securities).

First Comment. As to the programme level look-through, we believe that even before a sponsor bank qualifies for IRB, the sponsor should be permitted to generate internal ratings of unrated conduit positions by following published rating agency criteria. So long as banks are able to input certain key factors that are typically developed as part of the structuring process but are not necessarily fixed model inputs (*e.g.,* discounts associated with maturity mismatches between the life of the vehicle and the life of the underlying pool), we believe this could be a reasonable approach that would be manageable from an implementation standpoint. These internally generated ratings should then be used to assign the various positions to the risk weights corresponding to an identical external rating.

In the example described above, the sponsor should be able to apply rating agency criteria to determine a rating for the €90 million unrated senior interest. If the rating so determined was BBB, then the programme letter of credit would have two underlying assets: the internally rated BBB asset from the first transaction and the externally rated A asset from the second.

Second Comment. Also with respect to the programme level look-through, rather than assigning a risk weight to a second loss credit enhancement based upon the highest risk weight of any underlying asset, we believe that it is more appropriate to assign a risk weight that equals the weighted average of the underlying risk weights, as this better reflects the risk of that pool.

In the example described above, we believe the appropriate risk weight for the second loss enhancement would be 75%, since one-half of the underlying assets have an external rating of A and thus a risk weight of 50%, while the other half of the underlying assets have an internal rating of BBB and thus a risk weight of 100%.

Third Comment. If the Committee does not accept our first comment above, then the Committee's proposal will only be practicable if transaction level look-through is permitted for unrated asset-backed positions that are covered by the second loss enhancement that is under consideration. The Consultative Paper did not expressly state that transaction-level look-through is permitted, and we request that the Accord remedy that omission.

In the example above, if the Committee did not permit the sponsoring bank to use an internally derived rating on the €90 million unrated senior interest, then the sponsoring bank would need to apply a transaction level look-through to that transaction.

Fourth Comment. Also with respect to the transaction level look-through, when the underlying assets are exposures to corporate obligors, we believe a 100% risk weight should be applied to the pool. Credit and risk analysis is done at the pool level as opposed to the individual obligor level in securitisations. Essentially, the unrated corporate risk in a securitisation is that of the pool. Therefore, we believe that the 100% risk weight for unrated corporate exposures should be assigned to the pool. Additionally, we believe this limitation is appropriate because virtually all conduit transactions are structured to an investment grade level in order to maintain the rating of a conduit's ABCP, and 100% is the highest risk weight category applied to investment grade corporate positions.[13]

In the example above, the sponsoring bank should be permitted to assign a 100% risk weight to the €90 million senior position, rather than having to determine risk weights for each and every underlying corporate obligor.

Fifth Comment. Finally, although we think that the Committee appropriately does not view sponsor-provided programme level support as a "first loss" position (but rather as a second loss or more senior position, as appropriate) where seller-provided or other transaction level credit enhancement exists,[14] some readers have been uncertain about this. We would appreciate a clear statement to this effect in the final Accord.

b. Treatment of First Loss Programme Enhancements

We do not believe that an automatic deduction from capital is appropriate for first loss positions provided by sponsor banks. Rather, we believe that the minimum capital requirements for first loss credit enhancement positions provided by conduit sponsors should be established based on the credit quality of those positions, not on the fact they are being provided by a bank as a conduit sponsor. Furthermore, we do not see any reason to treat sponsor-provided first loss positions differently than first loss positions provided by investors or, for that matter, originators.

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[13] This same methodology should also be available for exposures to sovereigns and banks (*i.e.*, the risk weight applicable at the investment grade level for those types of exposures should be applied to pools consisting of those exposures).

[14] See in particular the discussion set forth in paragraphs 39 through 42 of the Securitisation Paper.

First, linking the capital requirements to the credit risk of a position under an ERB or IRB directly serves the important goal of aligning required capital to actual risk. While the role a bank plays in providing credit enhancement may implicate other areas of concern for regulators, we do not believe these additional concerns in any way change the fundamental proposition that the risk of a position remains the same irrespective of who provides that position.

We believe that other areas of the regulatory framework provide safeguards to address non-credit related risk. For instance, were an originator to provide implicit recourse to prevent a transaction from defaulting, a regulator would have the ability to require that originator to return some or all securitised assets to its risk-based capital calculation. Prior to applying an IRB, a bank will be required to satisfy its regulators that its internal ratings system is sufficiently developed to assess the risks of potential investments. We believe that regulatory tools such as these are the more appropriate means of addressing additional "role" risks.

Second, we do not believe that the integrity of the capital system will be compromised by allowing reliance on an ERB or an IRB for the calculation of required capital for first loss credit enhancement positions. Under either approach, regulators must approve the entity that will be rating a particular position prior to that entity being permitted to calculate the credit risk of a position. Furthermore, regulators will have the ability to satisfy themselves of the continued integrity of the system through supervisory review.

Third, because both rating agencies and banks take into account the relative subordination of a position when assigning a rating to that position, the increased risk of a first loss position will be reflected in the rating assigned to that position. We therefore do not believe that the level of subordination of a position should serve as an additional distinction for determining regulatory capital as it will be addressed in the ratings assigned to that position.

For these reasons, we believe that if a position is rated by an external rating agency or under a qualifying internal ratings system, the capital requirement should be derived from the standard risk weights assigned in the ERB. If a position is not rated, but a bank is qualified for the IRB, its internal rating of the position should apply.

If the Committee were not willing to allow a full IRB, we also propose an alternative that would allow a bank to use a qualified external rating agency's methodology to internally assign a rating to a first loss position which would be used to determine the required capital under the standardised approach. Most first loss positions are not assigned a rating by an external rating agency. Thus, to avoid higher capital requirements if an IRB were not permitted, a bank would have to incur additional costs and delays to have its first loss positions externally rated. We do not feel that such costs or delays need to be incurred if a bank itself is willing to apply an external rating agency's methodology to determine an assigned rating. We feel that there would be sufficient protection to the system provided through regulatory review of the proper application of this methodology by a bank's supervisors.

Additionally, while we continue to advocate a full IRB, we believe, at a minimum, the look-through approach available for investors providing credit enhancement should also be available as an alternative for sponsor banks providing first loss credit enhancement.

c. Treatment of Sponsor Putting its own Assets into a Conduit

While we agree that a sponsor assumes the role of originator in certain respects when it transfers its own assets into a conduit sponsored by it, we do not believe that the role in which a bank provides a credit enhancement position should affect the required capital for that position as it does not affect the risk of that position. Therefore, for the same reasons discussed in Section 4.1(b) above, we believe that a sponsor/originator should not be required automatically to deduct from capital credit enhancement positions related to securitisations of its own assets. Instead we believe both an ERB and IRB should be fully applicable to these positions.[15]

Should the Committee elect not to adopt this recommendation wholly, we believe that the final Accord should clarify that a sponsor/originator should only be required to deduct from capital that portion of credit enhancement that is available to cover losses on assets securitised by it. This would, of course, include any retained interest in the assets and any other transaction-specific credit enhancement positions of the sponsor/originator. We want to emphasise, however, that it should not include all programme credit enhancement provided to the conduit by the sponsor. Rating agencies that rate the commercial paper of a Multi-Seller Conduit will require that originator/sponsor securitisations be structured to the same ratings level as all other transactions in the Multi-Seller Conduit. Therefore, because a programme credit enhancement provider will have the same benefit of this first loss protection in a securitisation of its own assets as with any other transaction, we do not believe that the treatment of programme enhancement should be affected by the fact that the sponsor has put its own assets into the conduit. At the very most, the deduction from capital should only relate to that portion of the programme credit enhancement available to be drawn for losses on the sponsor/originator's securitised assets. For instance, if the sponsor provides a €10 million letter of credit as programme enhancement but only €1 million could be applied to cover losses on its securitised assets, we believe that only €1 million should be deducted from capital. The balance should continue to be treated as though the sponsor had not securitised its own assets.

4.2. Comments on Proposed Treatment of Liquidity Commitments

a. Calculation of Required Capital for Liquidity Commitments

We have several comments relating to the calculation of required capital for liquidity commitments. First, we support the continuation of the current method of calculating

[15] As discussed in Section 2.2(b), we acknowledge that to the extent new assets are created in connection with a securitisation the originating bank should be required to hold capital against these new assets.

required capital for liquidity commitments under which the credit equivalent amounts of off-balance sheet items are multiplied by their applicable risk weight before the application of the related conversion factor. Second, we believe that an IRB approach should be available when determining the risk weight for the applicable off-balance sheet item. Finally, we have three comments on the application of the look-through approach proposed by the Committee for unrated securitisation positions. First, rather than assigning a risk weight based on the highest risk weight of an obligor in a pool, we believe that it is more appropriate to assign a risk weight that equals the weighted average of the underlying risk weights. Second, we believe that a 100% risk weight should be applied for a pool of assets with corporate obligors. Third, we believe that programme liquidity commitments should be assigned a risk weight based on the long-term equivalent rating of the short-term rating on the ABCP issued by a conduit.

Calculation Method

Under the current capital accord, the credit equivalent amounts of off-balance sheet items are multiplied by the applicable risk weight in determining the minimum capital associated with the off-balance sheet item. For example, assume a 2-year commitment to make loans aggregating up to €1,000 to an OECD bank. Under the current regulatory scheme, the capital requirement calculation would be 50% x 20% x 8% x €1,000 = €8.00 (credit conversion factor x risk weight x minimum capital requirement x stated commitment). Although the Securitisation Paper implies the continuation of this approach,[16] some readers have been uncertain as to whether the Committee is proposing to eliminate the risk weight factor from this calculation. If this were the case, using the same assumed commitment discussed above, the capital requirement calculation would be 50% x 8% x €1000 = €40.00 (credit conversion factor x minimum capital requirement x stated commitment), a change in current practice which would in our view be unwarranted and distortive.

The Forum strongly believes that the regulatory capital requirement for commitments must continue to take into consideration both the likelihood of draw under a commitment (the conversion factor) and the risk of default if drawn (the risk weight). Assume a 1-year commitment to a Multi-Seller Conduit to fund €1000. Further assume that this commitment relates to an asset pool that is rated AAA. The on-balance sheet position of this commitment would be assigned a risk weight of 20% under the proposed rules. Therefore, the regulatory capital requirement calculation for the unfunded commitment under the Committee's proposal would be 20% x 20% x 8% x €1000 = €3.20 (conversion factor x risk weight x minimum capital requirement x stated commitment). Assuming the Committee accepts our proposed 10% conversion factor discussed in below, this calculation would be 10% x 20% x 8% x €1000 = €1.60

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[16] For instance, paragraph 55 of the Securitisation Paper says that liquidity enhancements may be "converted at 20% and **generally** risk-weighted at 100%." (emphasis added). The use of the term "generally" clearly implies that sometimes these commitments would not be risk-weighted at 100%. The only reason we can see why that would happen is because the risk-weighting on the underlying assets would apply.

Eliminating the risk weight factor from the calculation for regulatory capital for commitments eliminates the mechanism for assessing the underlying credit risk of loss to a bank associated with funding a liquidity commitment to a Multi-Seller Conduit. This results in a regulatory capital requirement that could be significantly higher than the overall risk of the bank's position, for positions rated A- or above, and significantly lower than the overall risk of the bank's position, for positions rated BB+ and below. Either result moves the regulatory system in the opposite direction from its stated goal of aligning minimum capital with the risk of a position.

IRB and Look-Through

We believe that an IRB should be available for determining required capital for liquidity commitments. If a full IRB is not available to a bank for any reason, then a two-step look-through process should apply, similar to the one described above for second loss credit enhancements:

$ the risk weight of the liquidity is determined by looking through to the underlying conduit position(s) (the "*liquidity level look-through*"); and

$ often the underlying conduit position(s) will be unrated securitisation positions, and their risk weights may (depending upon the Committee's reflection of our comments in the final Accord) be determined using the general look through treatment that the Committee has proposed for unrated positions (the "*asset level look-through*").

As with second loss programme credit enhancements, we believe that:

$ Even before a sponsor bank qualifies for a true IRB, the sponsor should be permitted to generate internal ratings of unrated conduit positions by following published rating agency criteria, and these internally generated ratings should be used to assign positions to the risk weights corresponding to an identical external rating.

$ If the Committee does not accept the recommendation immediately above, then the Committee should permit asset level look-through, and when the underlying assets are exposures to corporate obligors, a general 100% risk weight should be applied to the pool.

Finally, we would suggest the following modification to the look-through approach when used to determine the appropriate risk weight for a programme liquidity facility. One requirement for a commitment to be treated as a liquidity commitment under the proposed Accord is that the facility is not subordinate to the interests of the ABCP holders—in other words, its interest must at least be a *pari passu* interest. Because the credit risk for both rated and unrated programme positions that are *pari passu* is identical, we believe that the unrated programme liquidity facility should be "deemed" to have the same risk weight applicable to the long-term equivalent rating of the short-term rating on the ABCP for purposes of calculating required capital.

b. Appropriate Conversion Factor for Commitments

For reasons discussed below, the Forum believes that the assignment of a 20% conversion factor for short-term commitments overstates the risk of these commitments and believes that a more appropriate conversion factor for short-term commitments would be 10%.[17] While the Forum feels that a 20% conversion factor is too high for even corporate exposures, we particularly feel that the structure and purpose of liquidity commitments to Multi-Seller Conduits reduce substantially the risk that these commitments will actually be drawn in a particular transaction. In particular, asset-quality tests built into liquidity commitments and structural components of related underlying securitisation transactions serve to protect commitments from funding against non-performing assets. Thus, the risk of exposure of a commitment is effectively reduced to the extent that the underlying assets default. In the unlikely event that a commitment to a Multi-Seller Conduit is ever drawn, the funded commitment would be supported by performing assets. Additionally, at the time of draw, capital would be maintained against the amount of the drawn commitment.

First, liquidity commitments[18] are unlikely to be drawn in the ordinary course as they are back-up funding sources for the highly stable ABCP market, which is the primary funding source for Multi-Seller Conduit transactions. Because the ABCP market has historically been very stable, the likelihood of draws under an outstanding liquidity commitment to address market disruptions is minimal. Even in the turbulent capital market conditions in the fourth quarter of 1998 and the period of investor concerns over potential Year 2000 issues, the Forum is not aware of any draws on liquidity commitments to Multi-Seller Conduits due to market disruption or general inability to access the ABCP market even when some highly rated corporate borrowers were unable to access the corporate commercial paper market.

Additionally, liquidity commitments are not generally susceptible to draws for economic reasons when commercial paper rates spike, as the conduit administrator, not the customer, determines when to draw on liquidity commitments in accordance with the terms of a transaction. Because increased commercial paper costs are generally passed through to the customer, the conduit administrator, who is also typically a liquidity provider, does not have the same incentive that a customer would to fund through the liquidity commitment. Because customers are typically charged an increased margin for drawings under a liquidity facility, this option represents an unattractive funding source which, if utilised by a bank, would likely cause a client to seek alternative forms of financing.

Second, Multi-Seller Conduit transactions have structural features designed to allow an administering bank to maintain the stability of a receivables pool and mitigate the effect of defaults. These structural features include frequent pool reporting requirements, amortisation

[17] We are not commenting on the conversion factor for commitments of longer than a year in this paper.

[18] References to "liquidity commitments" in this section should be interpreted to apply equally to "parallel purchase commitments" discussed more fully in Section 4.2(c), below.

triggers for revolving facilities that permit the liquidation of a receivables pool once it fails to meet specified performance requirements, audit mechanisms that allow an administering bank to inspect its customer's operations and ensure proper servicing of the receivables pool and the ability when warranted of an administrator to take control of payment systems to provide for direct payments to the Multi-Seller Conduit, alleviating bankruptcy and fraud risk of its customers.

Third, liquidity commitments to Multi-Seller Conduits employ asset-quality tests designed to ensure that the level of an outstanding commitment at any time does not exceed the availability of performing assets. Such tests typically involve a comparison of the level of commitment to all or a specified percentage of the dollar amount of eligible non-defaulted receivables and cash proceeds balances. As defaults on a receivables pool increase, the availability under the committed facility decreases. In essence, these commitments are based on the quality of the underlying assets and effectively reduce the risk exposure of a commitment to the extent that they relate to the non-performing portion of the related pool.

Fourth, the credit quality of the assets that would actually be funded under a draw on a liquidity commitment is enhanced by the diversity and isolation of the underlying receivables pools. If called upon to fund a commitment to a Multi-Seller Conduit, the liquidity provider will be repaid from payments on a pool of receivables with a number of obligors, concentrations of which are typically limited in a given pool. Thus the deterioration of the credit quality of any one obligor typically has a minimal impact on the credit quality of the related receivables pool. Banks are also generally isolated from the credit risk related to the originator of receivables by their transfer to a bankruptcy-remote entity prior to funding through the Multi-Seller Conduit. Furthermore, because the underlying receivables pools often liquidate quickly, the length of exposure to any one obligor is often minimal. Although we understand from discussions with staff that they are concerned about the presence of greater systemic risk in securitisation positions, as discussed in Section 3.1 above, credit enhancement is sized to absorb any potential increases in systemic risk.

Fifth, liquidity commitments in Multi-Seller Conduits have the benefit of the first loss position provided at the customer level. Credit enhancement is sized to absorb losses in securitisation transactions. Even under a new regulatory capital scheme, banks will continue to hold capital against programme credit enhancement (whether funded or unfunded) at the required risk weight. Thus capital is already being maintained in the system for the credit risk of securitisation transactions.

Sixth, a distinction between commitments generally (including back-up commitments for corporate commercial paper back-up lines) and pure ABCP liquidity commitments is also supported by differences in the relationship between the amount of the commitment and the related outstanding commercial paper. Corporate back-up lines are not required to cover 100% of the corporate's outstanding commercial paper, but in most cases ABCP liquidity commitments are required to cover at least 100% of the related ABCP. As a result, in the unusual circumstance where an ABCP liquidity commitment is drawn, the amount drawn is

likely to be a smaller percentage of the commitment than is the case for corporate back-up lines.

Seventh, the utilisation history of liquidity commitments (including parallel purchase commitments) of the Multi-Seller Conduits administered by certain sponsoring banks supports the argument in favour of a continued exemption from capital requirements for short-term commitments. The Forum understands that a group of sponsoring banks may provide data on this point to the Committee.

Because of their short term and structural features that effectively reduce the credit risk and risk of draw under these commitments, as supported by the historical draw information referred to above, the Forum believes that the assignment of a 20% conversion factor for short term liquidity commitments overstates the risk of these commitments and believes that a more appropriate conversion factor for short term liquidity commitments would be 10%.

c. Draw Limitation Requirement for Liquidity Commitments

The Forum believes that the requirements limiting the circumstances under which a commitment can be drawn that are set forth in subparagraph 54(d) of the Securitisation Paper are unnecessary and sufficiently vague as to cause confusion and should be eliminated. Having made this comment, we want to make clear that we support what we believe to be the intent behind the inclusion of this provision—that there should be a distinction between liquidity, on the one hand, and credit enhancement and direct credit substitutes, on the other hand.

First, we would appreciate it if the final Accord would clarify that the limitation that a facility "not act as a permanent revolving facility" is not meant to preclude liquidity treatment for short-term commitments that are renewed annually. We believe that so long as a short-term liquidity commitment is subject to full credit review prior to annual renewal, it would be inappropriate to consider it a "permanent revolving facility". The fact that one or even multiple renewal requests are granted does not mean that anything less than a full credit review was done prior to such renewal. Nor does any one renewal suggest that the next request will automatically be granted. In fact, banks do refuse to extend their liquidity commitments from time to time. As the Committee acknowledges in paragraph 47 of the Securitisation Paper, a commitment of one year or less, as opposed to a longer term commitment, genuinely reduces a bank's potential credit risk by reducing the duration of its commitment.

At a minimum, if a regulator does not feel that a bank is conducting an appropriate annual review of the credit risk of a commitment, the end result should be that the commitment be treated as a long-term commitment not as credit enhancement, as paragraph 54 of the Securitisation Paper could be read to suggest.

Second, we are also concerned that the draw limitation requirement could be interpreted to mean that only commitments that permit a draw in the event of a general ABCP market disruption could be considered liquidity commitments. We do not think that would be an

appropriate interpretation. Rather, we believe that commitments so limited could be considered unconditionally cancellable as the Committee suggests in paragraph 46 of the Securitisation Paper, thus theoretically qualifying for a 0% conversion factor. Thus, any draw limitation requirement for liquidity commitments must be broader than this limited circumstance but narrow enough to distinguish between liquidity, on the one hand, and credit enhancement, on the other hand. We believe that the appropriate distinguishing limitation is the presence of a reasonable asset quality test, ensuring that funding will not be provided against bad or deteriorating assets as specified in subparagraph 54(f) of the Securitisation Paper.

We note that there are a number of reasons for drawing on a liquidity commitment that are not related to pool performance issues which should not cause the ineligibility of a commitment as liquidity. These include conduit management, administrative convenience and client and investor relationship issues, including permitting temporary funding to cover small exposures, providing short term (typically one day) swing-line funding for exposures, and permitting reallocation of commercial paper maturities.

Also, we believe that any limitations on draws beyond the asset quality test limitation unfairly discriminate against asset-backed liquidity commitments. So long as a liquidity commitment does not provide credit enhancement, it is, generally speaking, the functional equivalent of a corporate back stop facility. There are no comparable criteria for usage of corporate commercial paper back stop facilities.

Finally, we note that regulators will continue to have the ability to require greater capital to be held for those commitments that they view to be disguised credit enhancement.

For these reasons, we believe that the requirements limiting the circumstances under which a facility may be drawn and requiring that a facility may not act as permanent revolving funding more fully specified in subparagraph 54(d) of the Securitisation Paper should be eliminated from the proposed rules governing the characterisation of a commitment as liquidity.

d. Scope of Treatment for Liquidity Commitments

The Forum would like to have the scope of treatment for liquidity commitments clarified in two respects in the final Accord. First, we note that the discussion of liquidity commitments in the Consultative Document occurs solely in the context of commitments of a bank as a conduit sponsor. As a matter of course, a portion of a liquidity commitment for a particular transaction may be syndicated to several banks other than the conduit sponsor. To avoid any confusion as to the scope of the application of the rules governing liquidity commitments, we believe that the final Accord should make clear that liquidity treatment applies to all banks providing liquidity to a conduit.

Second, it is also a common market practice that a bank providing a liquidity commitment for a particular transaction enter into two interrelated commitments. The first commitment is the liquidity commitment as contemplated in the Consultative Paper. The second commitment is

an equal parallel commitment that runs directly to the transferor of the assets into the conduit. The parallel commitment is entered into so that the conduit itself does not have to make a commitment to fund additional purchases of assets from time to time in a particular transaction. Instead, it is given the option to have the liquidity provider fund those draws directly.

The inclusion of a parallel commitment allows a conduit to do directly (fund through a liquidity provider) what it otherwise would do indirectly (draw on liquidity). The decision as to whether to fund through liquidity or a conduit is generally at the conduit's discretion, not the client's. Further, like a liquidity commitment, a parallel purchase commitment will fund against performing assets and will represent a *pari passu* interest with liquidity draws on the cash flows from a particular transaction. Finally, to the extent that a bank's liquidity commitment is drawn, the availability under the parallel commitment is correspondingly reduced. Functionally, the dual liquidity/parallel commitment is essentially one commitment to a transaction that can be drawn in two different ways. We believe that the final Accord should make clear that (x) liquidity treatment applies to parallel purchase commitments that function in the same way as liquidity commitments and (y) a bank need only hold capital against the stated amount of the liquidity commitment since at no time does available commitment amount under these related commitments exceed the stated amount of the liquidity commitment.

4.3. Proposed Disclosure Requirements

We read the Consultative Document's disclosure requirements for SPVs as potentially applying to Multi-Seller Conduits. If this is the intent of the Committee, we feel strongly that the level of detail not only greatly exceeds that which is necessary to assure transparency or currently required by the market, but also could serve to overshadow the material information relevant to investors in ABCP. Overall parameters, such as credit and investment criteria and structure requirements for transactions done in a conduit are the relevant material disclosure for ABCP investors. The sheer volume of material that would be generated with the level of deal-by-deal disclosure proposed could actually serve to reduce rather than increase transparency. Furthermore, we feel that current bank and securities regulations, accounting and other required disclosures provide investors and other interested parties with all material information on the activities of a Multi-Seller Conduit. Finally, we note that Multi-Seller Conduits function like a bank or other lending institution that provides funding to a number of customers. We believe that more general disclosure such as that required for a bank is therefore more appropriate than the specific disclosure required for a particular originating entity.

5. Synthetic Securitisations

Synthetic securitisations represent modern risk management techniques that allow institutions the flexibility to use tranching to disaggregate risks associated with credit portfolios. They allow institutions to transfer various risk positions in either funded or unfunded form to market participants, depending on market conditions.

While these transactions represent a confluence of other risk mitigation techniques—including credit derivatives, credit–linked notes, guarantees and components of traditional securitisations—we believe that a holistic approach to synthetic securitisations as a distinct class of innovative risk management transactions is appropriate. Alternatives that would simply assign regulatory capital charges to individual components of a synthetic securitisation, would result in an aggregation of capital charges and impede further development/innovation of risk management techniques.

Instead, we recommend a hybrid approach that: (i) identifies certain components of synthetic securitisations and treats them consistently with their treatment elsewhere under the Basel capital adequacy framework, while (ii) recognising the benefits of the risk measurement and quantification process associated with either obtaining qualified external rating agency evaluations of various risk positions within these structures or, for qualifying institutions, internal ratings evaluations. Such an approach could be based on a small number of basic requirements, would be simple/practicable to apply and would accommodate institutions operating under the standardised approach.

5.1. First Loss Positions

Consistent with our position in Sections 2.1(a) and (b) above, we believe that the treatment of first loss positions in synthetic securitisations (regardless of their format) should follow the treatment accorded to traditional securitisations. We believe that there should be no difference in the capital treatment for the holder of a first loss position in a synthetic securitisation based on whether it is an investing bank or an originating bank. This is especially the case where external ratings exist for such positions. This potent capital charge is widely recognised as a prudent supervisory tool and we believe it eliminates in great part, any need to require a threshold level of risk transference or a restriction on the size of the first loss position, especially when considered in conjunction with our other suggestions presented below.

5.2. Note Treatment for Originating Banks

Traditional synthetic securitisations have a mezzanine position senior to the first loss position and subordinate to the senior risk position. In those cases where the mezzanine position is sold to third parties and cash or highly-rated eligible collateral is held in an SPV for the benefit of the originating/beneficiary institution, we recommend a 0% capital charge be assigned to the originating institution for that exposure. This is consistent with the current Accord and current practice and it recognises that the risk of this position has been transferred from the originating institution to the note holders. Where an originating institution retains such a mezzanine risk position, the treatment should be consistent with that which would be assigned to any investing institution.

5.3. Super-Senior Risk Positions

In recognition of the Committee’s ratings-based approach and the need for specific recognition of synthetic securitisation transactions, we believe it would be appropriate to

recognise the implied credit quality of the most senior risk position (a so-called "super-senior" position) in synthetic securitisation transactions, whether or not a swap covering this super-senior position has been entered into by the originating bank.

We support making such recognition of implied ratings on un-hedged super-senior risk positions subject to two conditions. First, the retained first loss position must be deducted from capital by the originator, and the next most senior note position demonstrably legally subordinated to or *pari passu* with such super-senior position must achieve the highest possible rating (*e.g.*, AAA or Aaa) from at least one recognised external rating agency. Second, the originating bank must demonstrate the ability to evaluate the risk exposure of the retained positions and to provide adequate capital support for them via a functioning internal risk rating system and application of a credible economic capital assessment process.

We believe these recommendations, combined with the formidable structural criteria referred to above, can form the basis for a workable approach to synthetic securitisations that will allow banks internationally to manage credit risk on a more economic basis. Consistent with our comments on other aspects of securitisation transactions, we believe that as a result of our view that a bank's role in a securitisation does not affect the risk of its position with respect thereto, this treatment of senior positions should be applied to both originating and investing institutions. For the reasons provided in Section 2.2(b) above, we further believe that an originating bank securitising assets and retaining a first loss position in a synthetic transaction larger than the on-balance sheet capital requirement should not be required to hold more capital post-securitisation than it held prior to the securitisation.[19] Finally, in transactions in which these strict criteria have been met, we believe that a further condition requiring that the deducted retained first loss position be no greater than a reasonable estimate of the losses on the portfolio would not be necessary in order to achieve a sound capital treatment of a super-senior position and would be inappropriately economically distorting for many of the same reasons discussed in Section 2.2(a) above.

Where a super-senior position has been hedged with a third party, we believe that such position should carry a 0% risk weight due to the outstanding, market-validated credit quality of that tranche. In addition, we recommend that the implied credit quality of an un-hedged super-senior position be recognised fully and risk weighted pursuant to the general capital rules and the nature of the portfolio securitised. In appropriate cases (*e.g.*, a pool containing sovereign assets) the risk weight of an un-hedged super-senior position should be 0%, but, in any event, the risk weight of such a position should not exceed the 20% weight accorded to AAA exposures generally in the Accord.

[19] As discussed in Section 2.2(b), we acknowledge that to the extent new assets are created in connection with a securitisation the originating bank should be required to hold capital against these new assets.

5.4. The Use of "w" with Credit Derivatives

As the Committee has noted, the treatment of synthetic securitisations is closely related to the general treatment of credit derivatives used to mitigate credit risk. We wish to comment here on one particular aspect of that related topic. The Forum opposes the use of "w" to limit the effect of credit derivatives on risk weights. The minimum operating requirements that the Committee has proposed are sufficient to support a presumption that a credit derivative that is designed to fully guarantee an exposure will have the effect of completely substituting the protection seller's credit risk for the risk of the underlying obligor.

6. Treatment of Implicit and Residual Risks Arising from Securitisations[20]

The Committee has indicated that, upon concluding further work relating to implicit recourse and residual risks, the Committee may impose an *ex ante* minimum capital charge for securitisation transactions to address implicit and residual risks. The Forum strongly opposes any such incremental capital charge. We believe that the other elements of the proposed Accord require more than adequate capital in connection with securitisations. This is another instance where the Committee's conservative approach to securitisation threatens to handicap this safe and beneficial market with capital requirements that have no parallel in other bank activities.

7. Other Comments

7.1. Adoption Process for the Accord

First, we would like to commend the Committee and the staff for the time and effort that went into delivering the Consultative Document and accompanying papers—we recognise the tremendous effort involved in moving the regulatory system toward the stated goals of the Commission. Second, we are extremely grateful for the opportunity to work directly with staff members in developing an IRB for asset securitisations.

Because of the importance of the new Accord, the Forum is highly concerned that an artificial deadline is causing very complex matters to be handled with too much haste. Despite everyone's continued efforts, we believe that the current December deadline actually threatens to hinder the finalisation of proposed capital regulations for asset securitisations. Under the current time frame, members of the staff were forced to publish an incomplete proposal in the Consultative Document for comment. At the same time that industry participants and other interested parties are considering and commenting on these proposals, we understand that revised drafts are being prepared by the staff for submission to the Committee shortly after the comment submission deadline. We quite frankly do not see any time in the proposed schedule for the staff to review, consider and incorporate, as applicable, insights, helpful data and formal comments submitted on the Consultative Document.

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[20] Paragraph 545 of the Consultative Document.

While we appreciate the opportunity to work with the staff as they further develop proposals, we do not believe that this adequately substitutes for a formal comment process. We believe that another draft should be circulated for comment prior to issuing final rules. We believe that the December deadline must be set aside and that the Committee and staff need to develop a more realistic programme for publishing a fully developed proposal, allowing time for thoughtful analysis and input from industry participants, and setting a goal for adoption and national implementation based on a workable time frame. We believe that a more realistic process will actually speed up the development and finalisation of the rules to be included in that Accord.

7.2. Transition Following National Implementation

After the final Accord has been issued and any particular nation has completed its internal process for adopting the Accord, we believe a minimum of a two year transition period should be allowed in order to transition deal structures appropriately and to have time to have internal systems approved for an IRB.

8. Conclusion

The Forum support 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 Document. 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.

Should you wish to communicate with the Forum or any of its members on any issue, please feel free to contact Scott Rankin, Managing Director of the European Securitisation Forum, at +44.20.77 43 93 00 or via email at srankin@bondmarkets.com.

Respectfully submitted,

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Attachment A

Suggested Definitions[21]

"the term 'issuer' means a trust, corporation, partnership, or other entity engaged exclusively in the business of acquiring and holding eligible assets, issuing securities backed by eligible assets, and taking actions ancillary thereto".

"the term 'eligible asset' means-

(A) financial assets (including interests therein and proceeds thereof), either fixed or revolving, whether or not the same are in existence as of the date of the transfer, including residential and commercial mortgage loans, consumer receivables, commercial loans, trade receivables, assets of governmental units, including payment obligations relating to taxes, receipts, fines, tickets, and other sources of revenue, and lease receivables, that, by their terms, convert into cash within a finite time period, plus any residual interest in property subject to receivables included in such financial assets plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders;

(B) cash; and

(C) securities, including without limitation, all securities issued by governmental units".

[21] At least one jurisdiction may be in the process of adopting this language to provide a statutory "safe harbour" for transfers in securitisation transactions.