

15th March 2013

Secretariat of the Basel Committee on Banking Supervision
Bank of International Settlements
CH-4002 Basel
Switzerland
baselcommittee@bis.org.

Dear Sirs

REVISIONS TO THE BASEL SECURITISATION FRAMEWORK

Barclays welcomes the Basel Committee's consultation document "Revisions to the Basel Securitisation Framework" (BCBS236) and we acknowledge the significant amount of work that has gone into the paper and the importance of the issues the paper seeks to address. We note that the Committee would welcome proposals to improve the proposed revisions, we regret that in the limited time available, particularly once the supporting technical documents were released, we have been unable to provide more constructive proposals. Consequently we believe an additional period of consultation post the QIS would be highly productive in terms of working on alternative hierarchies and refining calibration of the approaches. Barclays would be happy to participate in such work.

In the response outlined below we present our key messages on the proposals, while answering the specific questions posed in the consultation paper in Appendix 1.

Executive summary

We agree with the Committee's intent to address the perceived shortcomings of the securitisation framework including cliff effects and reliance on ratings. We are concerned that whilst the proposals make progress in this respect they do not reflect the following issues:

- Securitisation is a necessary source of funding for the real economy and the market needs to be re-established on a sound footing with appropriate incentives to all participants;
- The proposals do not reflect some of the key changes undertaken in the EU and being undertaken elsewhere, including USA, to ensure that originator incentives are appropriate and the short-comings of the pre-crisis originate-to-distribute business model do not recur;

- Underlying asset class is a key explanatory factor when analysing losses on securitisation positions;
- We support hierarchy A rather than hierarchy B which appears to introduce cliff effects of its own. However, within that hierarchy we believe that the conditions for use of MSFA need to be relaxed and that the RRBA calibration is inappropriately conservative.

Securitisation is a necessary source of funding for the real economy

We support the BCBS's intention to make the securitisation framework more risk sensitive, reduce reliance on ratings, reduce cliff effects and introduce appropriate prudence and incentives for securitisation. Additional complexity should not be added unless there is a contribution to risk sensitivity. The proposals as drafted do not always follow this basic premise. The main indicator of securitisation losses over the course of the credit crisis was underlying asset type which is almost entirely ignored in the proposals. On the other hand, maturity factors, which are already included in external ratings in terms of differing levels of subordination, are double counted with a maturity factor in RRBA. The FSB's November 2010 report stated that re-establishing securitisation on a sound basis remains a priority in order to support the provision of credit to the real economy. We are however concerned that the proposals as drafted and calibrated may further stifle the securitisation market and make it harder for the real economy to be financed via the capital markets. If so, this would be contrary to the mandate set for The Joint Forum¹ and also the recent FSB document on "Financial regulatory factors affecting the availability of long-term investment finance"². The latter recognises the importance of "a safer, sounder and therefore more resilient financial system" and notes that the reforms do not specifically target long term finance. The analysis does not include BCBS236 where longer dated securitisation exposures are specifically targeted. We are concerned that whilst that document sees more of a role for institutional investors in providing long term finance, that will be harder to achieve in securitisation form if banks are less able to provide market liquidity and hedging solutions due to overly prudent regulation.

Liquidity buffer requirements, increased market/regulatory transparency, and the strong, proven credit performance of European AAA-rated prime mortgage securitisations has increased bank investor participation. 52% of securities where we ran the book building process were sold to banks in 2010 increasing to 56% in 2011 (50% in 2012). We would expect bank participation to pick up as the LCR changes regarding highly rated ABS become effective, in conjunction with loan-level data and PCS initiatives. Most AAA prime mortgage securitisations would fit into the 5 year maturity category at initial issuance in line with the average maturity of the underlying assets and the updated RBA risk weights as set out here would increase capital requirements for a bank investor by over 8 times versus current levels, despite the fact that default experience is 0.10% for these bonds³.

¹ Report on asset securitisation incentives <http://www.bis.org/publ/joint26.pdf>

² http://www.financialstabilityboard.org/publications/r_130216a.pdf

³ Fitch Ratings Global Structured Finance 2011 Transition and Default Study, 16 March 2012

Proposals do not reflect underlying asset quality nor changes to the securitisation market

We are concerned that the focus on bond maturity to drive increased capital is a less relevant credit input than, for example, the underlying asset class or transparency of structure. The weightings as currently set out could significantly reduce investment levels in European AAA RMBS and could negatively impact European prime mortgage origination and pricing over time. Similar dynamics would be expected in other markets including the US, in particular for asset classes which have had benign loss experiences.

The examples highlighted in the consultation paper appear focussed on the experience of poor quality securitisation during the credit crisis. There appears to be little or no reflection of the performance of differing asset classes during the crisis and little or no recognition of subsequent changes to the market. Senior tranches of a large securitized products universe have not suffered significant principal losses over the last 10 years (including credit cards and auto loans in both the US and Europe). Some key examples are set out below:

- Poor loan underwriting standards in the originate-to-distribute model have been addressed in the EU by Art 122a of CRD2 and will be resolved in the US by the originator retention requirements of Dodd-Frank. Other jurisdictions are also following suit in introducing such requirements;
- Poor rating standards have been addressed at least in the EU as a result of rating agency process and also regulation of rating agencies and it is now much harder to achieve a AAA rating for a tranche of a securitisation. Consequently calibrating capital for a given level of rating based on the experience of 2006-8 vintage securitisations is not comparing like with like. The higher standards applied to ratings since the crisis are expected to be permanent due, at least in part, to the introduction of Credit Rating Agency regulation such as CRA2 in the EU; and
- Enhanced levels of disclosure of the underlying assets and their loss performance have been mandated in many jurisdictions enabling investors to perform their own due diligence before investing in ABS.

The BIS Working Paper “Securitisation is not that evil after all”⁴ reflected the significant concern that the originating bank benefits from asymmetric information and that there are perverse incentives regarding quality of origination and loan management post securitisation. That paper recognises the signalling benefit of originator retention (as implemented in CRD 2 Article 122a) and issuers’ concern to gain a reputation that would enable repeated access to this market. It concluded that the securitisation market can provide an appropriate tool for transferring credit risk efficiently. As the paper states “...the securitisation of prime mortgages is a soundly functioning market and should not be excessively penalised.” Consequently whilst we recognise the differing calibration in the consultation between a securitisation and a re-securitisation we believe that the approaches should be better calibrated to reflect historic performance of different asset classes rather than seemingly being calibrated to the worst asset class (i.e. US sub-prime mortgages). We recognise introducing an underlying asset type factor may introduce additional complexity but would suggest mitigating this by reducing complexity in other elements of the proposals. For example, the tranche thickness parameter may be unnecessary.

⁴ <http://www.bis.org/publ/work341.pdf>

Any proposed revision to the securitisation framework should incentivise and recognise appropriate behaviour from the point of view of the originator. For example, where originators do not publish pool level data on securitisations, or where securitisation structures become over complex, it is much harder for investors to undertake adequate analysis. Consequently additional conservatism could be introduced by the use of regulatory multipliers in such cases. We are concerned that the existing proposals are indiscriminate in their application of conservatism and therefore the outcomes are not always incentive compatible.

The calibration of the proposals seems excessive for most underlying asset classes

The Basel II capital framework is calibrated at a through-the-cycle level in order to avoid being pro-cyclical. This implies that there will be fluctuations in default probability over time. In keeping with this framework the capital charge for securitisation should be calibrated at the average of the cycle for the relevant asset class (with an appropriate level of stress applied) and not at the worst level for the worst asset class in history.

The Committee has expressed concern on capital volatility of thin tranches held for trading. This would present a combination of rating volatility and price volatility due to a higher chance of tranche wipe out in case of higher than expected losses. While we sympathise with the objective, the calibration of the tranche thickness approach overshoots this objective. A very thin tranche by definition will not have a material impact on the capital base of a bank and a material trading book would typically hold many tranches. This should provide some diversification and cross capitalisation between such other tranches on the book. Historic performance statistics do not justify a calibration of 100% correlation between tranches. An unintended consequence is that weighting of senior mezzanine tranches for retained positions (i.e. balance sheet CLOs) is very punitive and would result in banks having to purchase excessive amounts of protection to achieve capital relief. For a sample portfolio of a 5 year trade with BBB/BB rated assets (50% weighting) we have found that buying 0-5% protection would quadruple the amount of RWA to be held against the portfolio (in the absence of a KIRB cap). To bring the RWAs back to the original level 0-35% protection would have to be purchased. This is equivalent to 7 times the original Basel II capital at 10% Tier 1 or 177 times the Expected Loss on the underlying portfolio to get back to the starting position in capital. By extension the level of protection that would need to be purchased in order to achieve regulatory capital relief would be unjustifiably thick.

Multiplying the economic risk in portfolios for regulatory capital calculation purposes to reduce perceived risk has a detrimental effect on capital building/retention when banks are hedging their risk. Having to purchase more protection than economically necessary increases the expenditure and excessively reduces retained profit and thereby retained capital levels.

Purchasing very thick tranches for risk reduction does not only increase the cost but also raises the problem of how the bank can evidence Significant Risk Transfer. A very thick tranche is protected by the premium paid on outstanding notional. The current calibration of both MSFA and RBA approach requires tranche protection that is a multiple of the EL times duration of the underlying portfolio (and a multiple of the IRB capital as well). Given the conservative nature of the IRB models most banks will outperform their EL on their core

activities. This makes it more difficult to hedge core activities where banks have large loan exposures.

We are concerned that a market risk style charge for banking book assets embedded in MSFA (and hence RRBA) is justified by one of the Banking/Trading boundaries that was proposed in the Fundamental Review of the Trading Book. That version of the boundary, the mark to market boundary whereby any item with mark to market accounting will be subject to trading book capital rules, was rejected by most respondents as inappropriate. The fundamental review of the trading book is still underway. Inclusion of significant changes such as price volatility risk in what has historically been the banking book does not seem appropriate whilst the review is ongoing.

Model risk is quoted as an input in the recalibration as well but this is already built into the model construction framework implicitly through the various stresses. To assign an additional charge for such risk to securitisation would result in double counting risk in the securitisation framework.

It is unclear how the proposals would interact with trading book capital requirements

Feedback from the meeting between industry quants and BIS quants in Washington DC is that the proposals will only apply to the banking book but that a future trading book treatment will be developed as part of the Fundamental Review of the Trading Book and consider these same issues. We are concerned that unless the implementation of any changes to the securitisation framework is delayed until the implementation of the fundamental review that there will be either clear inconsistency between the banking book and trading book approaches or a direct read across of these rules to the existing Basel 2.5 framework. Under Basel 2.5 as implemented in Europe by CRD3, the RBA and SFA are referenced under existing trading book requirements, so any changes to these approaches need also be considered in a trading book context. Furthermore, a concern is that as drafted these rules are not well applied to a trading book business. Potential additional complexity of capital charges unrelated to internally modelled risk is unhelpful in a trading environment where it will be harder for those providing market liquidity to assess the capital consequences of a trade *ex-ante*. Furthermore an expected inability to access MSFA (see answer to Q4 below) and likely reliance on a crudely and overly conservative RRBA will increase the capital cost of market making ABS and hence reduce market liquidity.

We recognise the difficulty of defining a capital framework for a market with unlimited structural features and permutations of collateral. The danger is that low risk tranches are over capitalised in order to capture the potential arbitrage on higher risk transactions. Such market complexity also reduces investor understanding, bond fungibility/liquidity and thus the potential for market gaps. Standardisation of the structures and loan tape data would facilitate systematic and auditable risk assessment of the ABS market.

In such a future state, regulator-approved stress scenarios may be a suitable approach for assessing the capital requirements of such trades. This would be directionally aligned with how market participants analyse these structures (though participants apply differing levels of sophistication). The resulting loss profile will be smooth, i.e. it would not have arbitragable cliff effects. It would also be independent from rating agencies, encourage investor understanding, a transparent market and ultimately result in a liquid, fungible,

healthy market. The calibration of collateral behaviour to the stress variables, could be undertaken via historic calibration or from first principles. First principles would be especially useful when there has not yet been a stress event for a given asset class.

I hope you find our comments helpful. Please do not hesitate to contact Roger Versluys (roger.versluys@barclays.com or +44 207 773 2791) if you have any questions or comments on any of the issues raised in this response. Furthermore, we would be happy to continue to participate in the relevant fora to discuss the issues presented in this paper in more depth.

Yours sincerely,

A handwritten signature in dark ink, appearing to read 'Mark Merson', followed by a period.

Mark Merson

CFO Corporate and Investment Banking & Co-Head of Finance

Appendix 1: Answers to BCBS questions (1-24)

Hierarchy of approaches

1. What additional costs and benefits of the two hierarchies should the Committee consider? Which hierarchy presents the greater benefits relative to its drawbacks? Which hierarchy would best address the shortcomings identified with the current framework, whilst meeting the Committee's objectives?

On balance, we consider hierarchy A is closer to meeting the objectives and addressing the shortcomings identified, subject to the other points of feedback below.

Under hierarchy A, it is envisaged that the use of MSFA could be restricted by the supervisor for the structure or transaction. Similar to granting each jurisdiction a choice between RRBA and SSFA, the Committee should consider the impact of this discretion on the comparability of banks' capital requirements and the attendant effects on market confidence.

Hierarchy B appears to be driven primarily by concerns regarding potential model risk which is already intended to be addressed within the revised RBA and the MSFA. The Committee should balance this against the relative incentive effects created and the provision of credit to the real economy. Effectively, the restriction of the more risk-sensitive approaches to 'senior high-quality tranches' acts as a signal that banks should only hold tranches of this type. It is not obvious which constituency should hold 'all other tranches,' given increased capital requirements for insurers and concerns regarding risk transfer to shadow banks. In practice, this means a lower level of securitisation activity, with banks allocating their capital to existing credit exposures and with less capacity to originate new exposures.

For both hierarchies we are concerned that giving supervisors the unfettered ability to select differing hierarchies, restrict or prohibit using MSFA or SSFA could result in significant differences between jurisdictions. Similar situations have already occurred under the existing requirements where several European regulators unilaterally ceased to recognise SFA, pushing their banks towards RBA yet in the US moves are underway to eliminate the RBA and replace it with a SSFA. At a point where comparability and credibility of RWAs is an ever more pressing concern, introducing additional such optionality appears to be a retrograde step. We would propose that if there are structural factors which would undermine MSFA and SSFA they should be collated, listed and hence any bank would be able to understand that incorporating such factors would automatically result in withdrawal of these approaches.

2. As regards Alternative A, could both the revised RBA and the SSFA be accommodated without raising concerns about regulatory arbitrage or level playing field?

No. The revised RBA has been derived from the MSFA which, in turn, is based on the principles underpinning the IRB credit risk framework. The SSFA inputs are based on the standardised approach. The examples provided on p.24-26 illustrate how these different methodologies can produce widely divergent capital outcomes for the same risk exposure.

We are concerned that if no choice is available either the SSFA would be imposed on the non-US “rest of world”, thereby denying banks the relative simplicity of the RRBA or there would be a fundamental conflict between Basel requirements and US legal requirements. It appears that potential regulatory arbitrage/level playing field issues would be a necessary consequence of the US legal requirements. This could be mitigated by ongoing monitoring of RWA differences arising from the two approaches by a group such as the Standards Implementation Group.

3. As regards Alternative B, which methods could a bank use to conclude that a securitisation exposure is of high quality? Would the use of these methods likely result in a capital charge consistently related to credit risk across banks and countries? Would Alternative B produce material cliff effects as exposures deteriorate below high-quality?

We are not supportive of alternative B largely as a result of the issues set out in the question. The most objective measure is likely to be an external credit rating, although alternatives such as confidence intervals around the expected loss could also be used. Cliff effects would also be produced as tranches are repaid and the ‘most senior’ designation changes. As mentioned above, the use of two parallel approaches under Alternative B appears to be redundant given the fact that the MSFA and revised RBA intrinsically take into account the quality of the securitisation exposure, without the risk of creating a potential cliff effect due to calibration differences when switching from one approach to the other.

Furthermore, alternative B could have the impact of moving the majority of investor positions to BCRA as investors are unlikely to be able to calculate Kirb as required for CRKirb.

4. Are there alternative hierarchies or revisions to the two proposed (or a combination of both) that the Committee should consider?

Yes. Under hierarchy A, we agree that the MSFA should generally be the starting point because it is most coherent with the principles underpinning the general IRB credit risk framework. Alternative methodologies should be based on the MSFA, but using proxies for some of its inputs. In general, the trade-off for using simplified inputs should be more conservative outputs, i.e. higher capital.

We support the MSFA being at the top of the hierarchy but believe that the conditions for use are too onerous

The MSFA is extremely challenging to implement for parties other than the originator because of the need for individual AIRB loan level data on the entire asset pool. We note the comment in Working Paper No. 22 ‘Foundations of the Proposed Modified Supervisory Formula Approach’ which flags the possibility of using aggregate pool-level statistics as inputs to the formula. This could form a workable alternative to the internal assessment approach for ABCP conduit sponsors, who will have good pool level data but rarely to AIRB standard at the individual asset level. If that is not possible, the IAA would continue to be necessary as the fallback for unrated ABCP positions.

We concur that the RRBA approach should be at the next level of the hierarchy but are concerned about double counting of risk factors in its formulation

Working Paper No. 23 'The Proposed Revised Ratings-Based Approach' explains that the risk weights have been calibrated using the MSFA and fixed assumptions regarding the credit quality of the underlying assets. Given that tranche thickness and maturity are separately addressed, it is difficult to see what role the rating plays other than acting as a rough proxy for the attachment point. Furthermore, the maturity adjustment results in 'double counting' of the maturity effects since rating agencies require higher subordination levels for longer-dated deals. Example: In order to achieve a specific rating a 5-year deal requires a higher subordination than a 3-year deal (*ceteris paribus*). We note also that the use of ratings is not compatible with the provisions of the Wall Street Reform and Consumer Protection Act in the United States, nor the objectives of the Credit Ratings Agency Regulation in the European Union. As an alternative, banks could apply the MSFA with fixed supervisory inputs for the credit quality of the asset pool, so that the only variables are tranche attachment point, tranche thickness and tranche maturity. As noted below, the supervisory inputs could discriminate between different asset classes so as to reflect the variable performance of transactions during the financial crisis.

A simple concentration ratio should be used as a backstop. However, the more risk sensitive approaches should be more readily available so that the backstop does not become the norm

The Committee notes that the MSFA does not take account of deal-specific risk factors or structural implications. The UK FSA has made a similar observation in respect of the current SFA, citing the examples of non-sequential amortisation and senior swap payments. By contrast, a credit rating should encompass qualitative review which would be expected to take account of unusual features undermining credit quality. A solution here could be to define the transaction characteristics which have to be present (or absent) for the MSFA to deliver a robust result, whether this is with asset-level or pool-level data; transactions that did not conform would not be eligible for MSFA and would need to use the concentration ratio as a fall back method. This could also support the Joint Forum's recommendations on raising origination standards, reducing complexity and increasing standardisation so as to support the liquidity of structured products. So as to avoid constraining innovation unnecessarily, the specified characteristics could be reviewed by the Committee over time to take account of legitimate market developments.

The SSFA is not consistent with the rest of hierarchy A but appears necessary for a global framework.

The SSFA is based on the standardised risk weighting framework rather than IRB; the examples provided in the paper show that it does not produce outcomes consistent with MSFA. The examples on p.26 illustrate that this effect is more pronounced as the average PD of the asset pool increases i.e. users of the less sophisticated SSFA would have a relative incentive to hold junior and mezzanine tranches on lower quality asset pools. We do not think this is an appropriate outcome. As a result, are not supportive of the SSFA though recognise its importance in achieving an outcome that would be inclusive of US regulation.

Although we would envisage the MSFA acting as the calculation engine in most circumstances, the concentration ratio approaches should still be available as a simple alternative and as a backstop. Generally, we would expect the output of this approach to be the average risk weight of the underlying assets (for the most senior tranche) or 1250%. Banks should be required to justify their use of the concentration ratio approaches to ensure this is motivated by operational factors rather than regulatory arbitrage.

Revised Ratings Based Approach (RBA)

5. The Committee recognises that in some instances and in some jurisdictions, the requirement for two external ratings could be difficult to implement or could impose additional costs on banks. The Committee requests feedback on the relative merits of reducing idiosyncratic, rating agencies' modelling risk with the costs of using two ratings and/or whether exceptions to this treatment should be permitted.

On a practical level, we would ask the Committee to recognise that the number of rating agencies operating within the structured finance space is limited, so it is questionable whether material reductions in model risk will be realised through this requirement. Consequently we believe that there is little prudential benefit from requiring two ratings if not required for other reasons (such as under the EU Credit Rating Agency Regulation – CRA3). In addition to their limited number, not all rating agencies participate in all asset classes limiting even more the availability of multiple ratings.

Also, the cost of dual ratings may prove too expensive for some originators given that a single rating can cost up to USD\$250,000 upfront.

Furthermore, we would also observe that some agencies have withdrawn from providing coverage for transactions of a particular vintage or underlying asset class for reputational or other internal factors; in the absence of transitional requirements, it would be very difficult to satisfy a dual rating requirement on legacy business and consequently existing trades should be grandfathered out of scope of any dual rating requirement.

6. Is the RBA appropriately calibrated and formulated? Should other risk drivers be incorporated?

We welcome the publication of Working Paper No. 23 which explains the basis for the Revised RBA in a clear and transparent manner. We also welcome the principle that the Revised RBA should be based on the MSFA, which supports the overall coherence of the securitisation framework and has the potential to deliver more consistent outcomes for the same risk. We make the following observations.

The assumption that the underlying assets are B- is overly conservative.

We disagree with the assumption that assets underlying RRBA tranches will be equivalent to no more than a B-rated corporate exposure with the associated IRB asset value correlation and a fixed LGD; we note that this will produce very conservative risk weights for transactions based on retail assets or a bank's core loan portfolio.

Using credit rating as a proxy for attachment point results in double counting of maturity effects.

We disagree with the proposal to incorporate tranche thickness and maturity as separate risk factors as these will already be reflected in the credit rating – the working paper acknowledges the potential double count, but it does not explain why the rating agency's treatment of these factors is insufficient. Furthermore, we disagree with the assertion that ratings only address unconditional expected loss rather than stress events.

An example of how the RRBA yields inappropriately conservative outcomes for securitisation of high quality assets is included as appendix 2.

MSFA using pool level data could provide a credible alternative for IAA

Under the proposed framework, the credit rating effectively acts as a proxy for the tranche attachment point (A) or level of credit enhancement. Tranche maturity and thickness are the other variables, so the result is an approximation of the MSFA with fixed assumptions regarding the underlying asset pool. This raises the question as to why the MSFA cannot be used directly with aggregate pool-level statistics, which could reflect more accurately the credit profile of the transaction. We would envisage that the pool-level statistics would be:

- determined by the firm in the case of ABCP conduit sponsors, as a replacement for the internal assessment approach (IAA); and
- fixed by supervisors in all other cases.

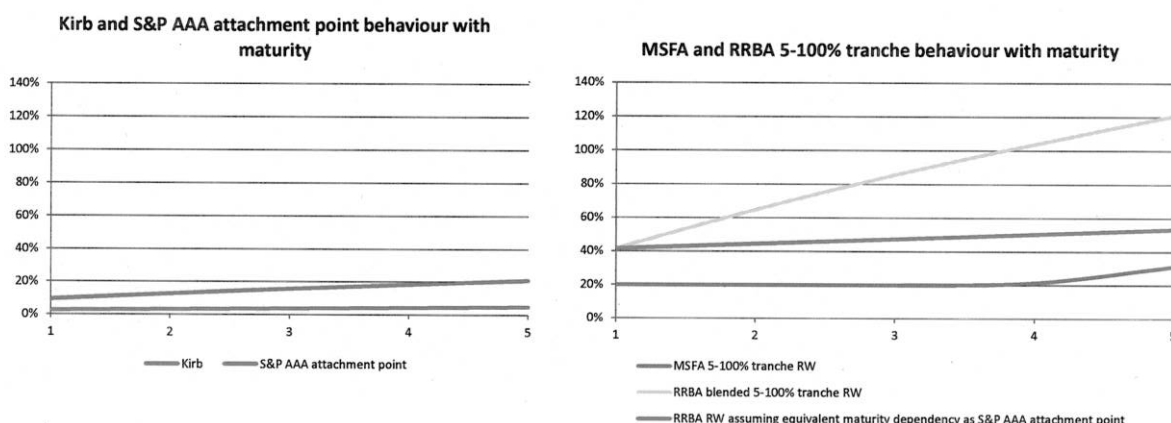
The supervisory estimates should discriminate between and within different asset classes in order to reflect their differing performance during the financial crisis. For example, BIS Working Paper 341 – 'Securitization is not that evil after all' suggests that transactions based on prime mortgages performed robustly during the crisis "and should not be excessively penalised." It is not clear why the capital charges for a prime mortgage securitisation should be calibrated assuming the underlying is actually a B-rated corporate.

Using fixed assumptions for pool quality is inappropriate. The quality of underlying assets was the key variable in determining credit losses on securitisations

The use of any fixed assumptions on pool quality raises the concern that capital requirements will be understated if the actual underlying pool quality is materially lower than the assumed value. The Committee has proposed addressing this by giving the supervisors the power to adjust capital requirements upwards for high-risk pools. We would suggest a better approach is to define and limit the circumstances in which each of the supervisory estimates can be used – for example, defining the characteristics of a prime mortgage pool using observable factors such as LTV. Where the asset pool does not conform to these characteristics, or the bank cannot demonstrate the pool conforms, more conservative pool-level statistics should be applied by default (for example, based on CCC corporates). As with our comments above on the hierarchy, this would support the Joint Forum's recommendation on improving origination standards, increasing standardisation and improving liquidity. Again, the specified characteristics should be reviewed on an ongoing basis by the Committee to take account of market developments.

The new RBA framework calibration tries to build a buffer for rating agency model errors through the RRBA. Again this is calibrated on the Sub-Prime history and subsequent downgrades. Apart from the debate as to whether this should be captured through the capital charge, we find that the rating agencies have all adjusted their models and in particular have added stress adjustments for any material aspect of these transactions. On top of that stresses for Aaa/AAA ratings have been increased even further. Comparison: AAA attachment point in 2006 at approximately 5% is now equivalent to 20+%. The recalibration of the RBA multiplies the impact of the rating agency model adjustments for existing ABS and therefore overshoots materially the required capital for ABS.

Below we have two graphs that show on the left difference between the maturity dependence of Kirb and the AAA attachment point using S&P CDO evaluator on a sample portfolio. On the right we show the risk weighing of a retained 5-100% tranche for that portfolio. We have included the AAA attachment point slope (red line) in the second graph to show that the RRBA is not just calibrated much wider than the MSFA but also has a much steeper maturity effect. The MSFA produces mostly the 20% floor value but starts to make an impact at the five year point. The RRBA produces mostly the 20% floor value but starts to make an impact at the five year point.



Part of the difference between Kirb and the Rating agencies is caused by the very conservative recovery values assumptions for assets that are to be rated. They combine asset types that are not necessarily comparable. For example, S&P CDO Evaluator uses the same recovery value for senior unsecured as second lien loans. The values used are far away from observed recovery rates for senior unsecured loans (large portion of wholesale loan books).

Senior Unsecured and Second-Lien Loan														
	Liability Rating													
	AAA		AA		A		BBB		BB		B		CCC	
Country Group	Mean	Std Dev	Mean	Std Dev	Mean	Std Dev	Mean	Std Dev	Mean	Std Dev	Mean	Std Dev	Mean	Std Dev
Group 1	18.00%	9.00%	20.00%	10.00%	23.00%	12.00%	26.00%	13.00%	29.00%	15.00%	31.00%	16.00%	31.00%	16.00%
Group 2	16.00%	8.00%	18.00%	9.00%	21.00%	11.00%	24.00%	12.00%	27.00%	14.00%	29.00%	15.00%	29.00%	15.00%
Group 3	13.00%	7.00%	16.00%	8.00%	18.00%	9.00%	21.00%	11.00%	23.00%	12.00%	25.00%	13.00%	25.00%	13.00%
Group 4	10.00%	5.00%	12.00%	6.00%	14.00%	7.00%	16.00%	8.00%	18.00%	9.00%	20.00%	10.00%	20.00%	10.00%

Some of the down-grade volatility that has been observed in the market is not caused by underlying credit risk changes but by adjustment of secondary features like country rating ceilings, swap counterparty limits and similar calibration issues. While these may not lead to an increase in credit risk/losses of the underlying pool, under the current framework the capital already steps up to protect against these additional risks. However since the framework does not distinguish between investments and retained senior tranches this results

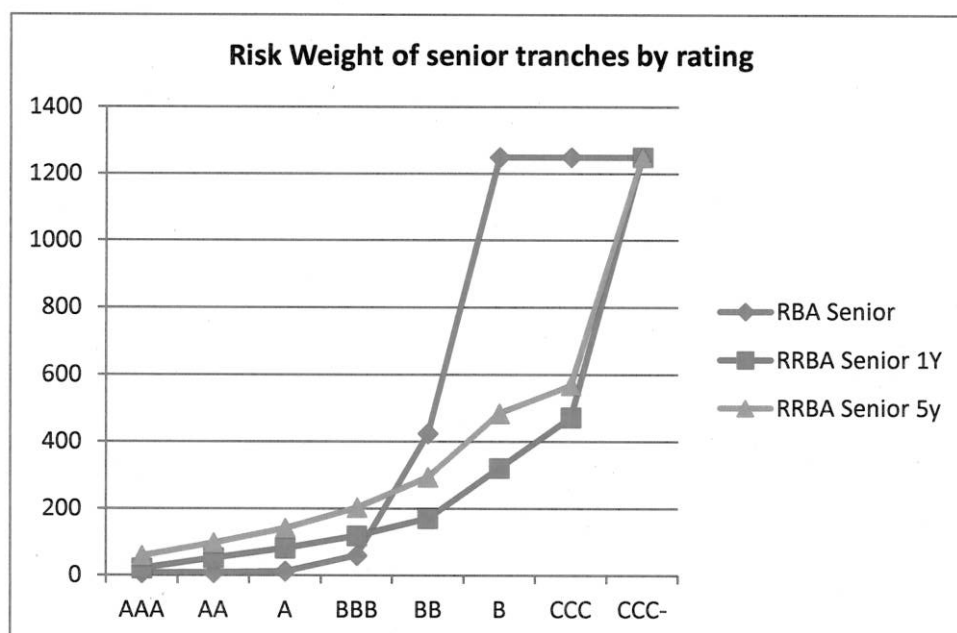
in a bank holding capital for its own risk, for example, in case of a bank in a BBB rated country.

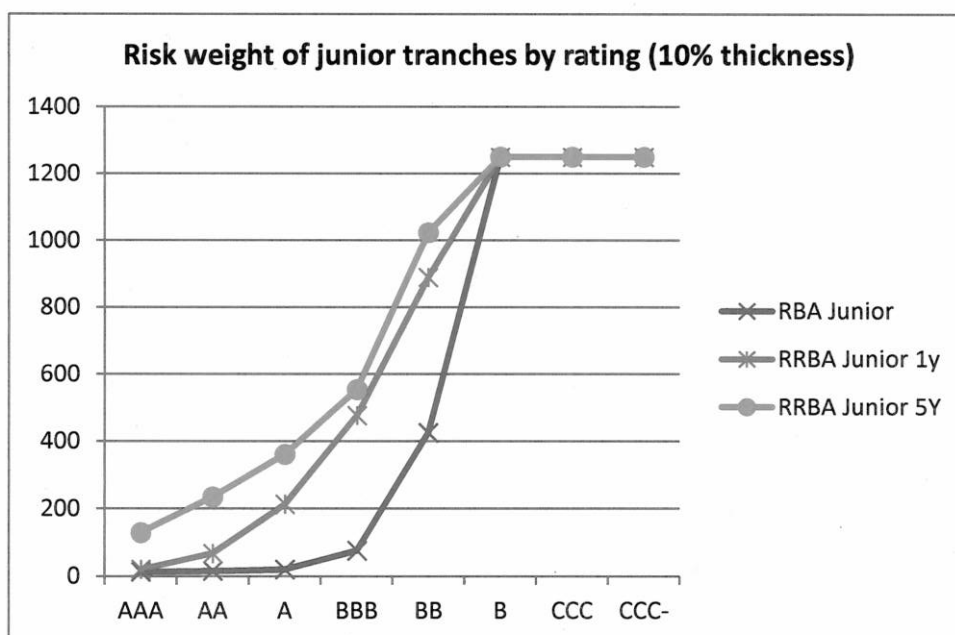
Double counting maturity effects in MSFA and RRBA create a disincentive to hedge risk

With the strong maturity effect on senior tranches the current calibration (MSFA and RBA) provides a material disincentive to hedge good quality portfolios for credit risk (actual defaults, in particular for names that do not trade in CDS) through a credit cycle (Say BBB-average for 7 years when spreads are low). This is multiplied in the RBA by the rating agency adjustments for maturity. We feel that there is a material amount of double counting as the IRB approach itself already takes into account maturity of the underlying loan exposures. Again in the case of hedging a portfolio, the capital for holding that same portfolio but now with credit protection leads to a material increase in capital to be held. The punitive treatment of longer term transactions strongly incentivises short dated protection trades which go against prudent through the cycle hedging in a benign credit environment

(i.e. hedge risk when economically viable capacity is available, not when you need it in a crisis as it maybe too expensive)

On the re-calibration for low rated tranches (BB and lower) we feel that this does not provide a very relevant addition as this is only applied to the most senior tranche. For hedging on-balance sheet portfolios the tranches junior to AAA are also retained (for example protection is purchased up to the BBB tranche) but the weighting on those retained tranches is far more conservative than the current model. There is some benefit for the occasion where the most senior AAA gets severely downgraded, but again this has only been observed for the Sub-Prime asset class and not for any other AAA rated senior piece.





While we appreciate there have been significant problems with certain securitisations in the past, we disagree with the view of the Committee that the risk in a portfolio increases exponentially just by tranching it although a moderate increase may be justified by the additional complexity. For example, using the RRBA on a GBP 4bn sample portfolio (general corporates, BBB- average rated) we find a stand-alone RWA of GBP 2bn and post tranching this increases to GBP 7.5bn. Buying 0-5% protection on this portfolio reduces the RWAs post tranching to GBP4.9bn or 2.5 times the original.

Securitisations are also used to convert illiquid loans on balance sheets to securities that can be pledged under ISDA CSA, repos and similar arrangements. We have long term AAA government guaranteed loans that under the current calibration will attract a 58% weighting just by repackaging them with a small level of overcollateralization.

It should be possible to infer ratings from pari-passu rated positions

It is unclear from the consultation paper whether it is still possible to infer ratings for unrated positions within the RRBA. This has historically been required for calculating the counterparty risk weighting for swaps undertaken with securitisation vehicles. The swaps are often senior to or pari-passu with the senior note but are not generally rated in their own right. Given the significant cliff effect between the most senior AAA note and a conceivable AA note as the second most senior note under RRBA it should be allowable to risk weight a swap which is pari-passu with the rated AAA note as AAA. This will be a move away from the existing requirement that the position from which the rating is inferred is junior in all respects. If regulatory authorities are concerned that this could somehow lead to regulatory arbitrage they could require reporting of such inferred positions and retain the right to challenge any egregious examples. Furthermore if there are positions such as swaps, fee streams or liquidity facilities which are senior to the entire balance of notes referencing the assets it could be argued that the recovery on this will be higher than that for the senior notes and a preferential risk weight could be applied.

7. Is it appropriate to require that in order for the MSFA to be used the IRB approach should be applied for all underlying assets?

In principle, yes; but the Committee should consider making available proxies for the IRB approach in cases where the necessary asset-level data is not available. This would include the use of aggregate pool-level statistics in the circumstances described above. Additionally, firms should be permitted to apply a conservative default risk weight to any individual asset for which loan-level IRB information is not available, rather than being disbarred from the approach altogether. Otherwise jurisdictions which use a model by model IRB approval approach such as the UK will be at a significant disadvantage compared to jurisdictions with an “all or nothing” approach to model approval such as the US. Furthermore the inability to apply AIRB to all underlyings may be a significant issue for smaller banks which would consequently be forced onto less risk sensitive approaches under either hierarchy and consequently more onerous capital treatments. The latter is also a further hurdle to overcome for new entrants in the banking market as they cannot rely on securitisation to fund themselves or manage the risk in their books.

8. Is the MSFA appropriately calibrated and formulated? Does it incorporate the appropriate risk drivers? Is the calibration of tau and omega appropriate? If not, what evidence can respondents provide to support an alternative calculation?

To respond fully to this question we would need a clearer statement regarding the Committee’s objectives in respect of securitisation: if we identify which types of behaviour should be encouraged or discouraged, we can then assess whether the MSFA creates the right capital incentives to support these goals.

The risk factors incorporated in the MSFA are clearly all relevant to the credit risk borne by the tranches, although we would question whether the effect of each is sufficiently material to warrant inclusion as a separate variable (for example, the use of both asset-level PD and asset-level AVC). We agree that tranche maturity is also a relevant factor, but note that the method by which it has been incorporated requires recalculation of the pool-level MSFA parameters for each tranche, significantly increasing the operational complexity of the calculation. The model component which tries to capture potential mark-to-market losses overstates losses for tranches which trade below par (i.e. tranches which have been written down) since the mark-to-market losses are calculated based on par value. Furthermore, risk mitigants such as (early) amortization and excess spread are not captured which overstates risk for a significant portion of the securitized products universe.

The calibration of the tau and omega factors appears somewhat arbitrary, but it is difficult to propose alternative values as these factors are intended primarily to address model risk. The calibration could be kept under review by backtesting the performance of the underlying formula (without supervisory add-ons) against the loss experience of actual transactions. Please see below for comments on the 20% risk weight floor that has been incorporated in both the MSFA and the Revised RBA.

By allocating a floor of 20% an additional problem is created for assets that are of good quality (less than 100% weighting) and partially drawn assets. Since the floor is applied to the entire notional of the transaction there is a material pickup for senior exposure compared

to the initial weighting of the portfolio (for example a 50% weighted pool now can only achieve maximum 60% relief). The undrawn exposure (i.e. when hedging the limit of partially drawn revolving credits) and the difference between the loan limit and the weighting now pick up capital by tranching the exposure. Therefore only very risky fully drawn assets could be considered for securitisation. However the rating agency models increase attachment points exponentially and the investor universe in that credit quality range is much more limited. A prudent approach to hedging through the cycle, i.e. BBB type assets when they are all performing, is thereby made impossible.

9. Is it prudent to allow the use of the MSFA by banks making use of the foundation IRB approach (i.e. not calculating internal estimates of the underlying loans' LGD)?

We believe the use of foundation LGDs can be accommodated within the MSFA in certain circumstances as the foundation estimates of LGD are generally more conservative than AIRB. The Committee could objectively define the asset pool characteristics which have to be present (or absent) for the MSFA using foundation LGDs to deliver a robust result. For transactions which do not conform, or where the bank is unable to demonstrate conformance, a more prudent estimate of LGD (potentially up to 100%) could be used rather than disbaring use of MSFA altogether.

10. Is the SSFA (particularly the constant term p) appropriately calibrated? Please provide justification and evidence, to the extent possible, for alternative appropriate levels of calibration?

It is unclear why the approach has been changed from the US proposal, such that capital for re-securitisations cannot be based upon the SSFA. Furthermore, it needs to be clarified how US student loans are captured by the W factor. Forbearances and deferments should not be included in the W factor. Both private and Federal student loans are structured to defer a borrower's payments during a specified period based on the borrower's student status. Most student loan products do not require payments while the borrower is enrolled in college and provide a grace period after graduation before payments are required. If such factors are not captured appropriately the RWAs associated with student loan ABS will not be reflective of the risk nor the legal framework underpinning the assets.

11. Is the SSFA properly formulated or should other risk drivers, such as maturity, be incorporated?

On a conceptual level, it is difficult to understand the need for the SSFA. Concerns regarding legal restrictions on the use of ratings could be addressed by adapting the MSFA to be used with supervisory estimates for the quality of the underlying asset pool. However, we recognise that the inclusion of SSFA may be necessary in order to ensure the proposed changes are acceptable to US regulators.

As the SSFA is not consistent with the MSFA or the IRB framework, it can produce significantly lower capital requirements than MSFA or the revised RBA. The Committee's examples show that this effect is most pronounced for low credit quality pools. We would therefore suggest that banks should only be permitted to use SSFA in cases where it can be demonstrated the underlying pool is within objective thresholds on asset type, credit quality and concentration.

We note that the SSFA can also produce significantly lower risk weights than RRBA for senior tranches where the maturity is greater than 1 year. We believe this divergence is best addressed by correcting the calibration of RRBA – in particular, the double-counting of maturity effects – rather than increasing the complexity of the SSFA.

Concentration Ratio Based Approaches

12. Has the BCRA been appropriately calibrated and formulated?

We note that this is not a risk sensitive methodology, but as the “fall back” approach the calibration is reasonable, subject to the risk-weight cap to ensure that the most senior tranche is not unduly penalised.

We note the Committee’s concern that a bank could claim inability to calculate IRB on an underlying pool of exposures in order to access indirectly a preferential risk weighting derived from the standardised approach. We believe a better approach to addressing data paucity issues (real or otherwise) is to rely on supervisory estimates at the pool level.

Regardless, this approach is expected to be highly conservative as it does not give any credit to subordination or any other credit enhancements.

13. What factors should the Committee consider in weighing whether the F parameter should be set at 2 for senior as well as non-senior tranches to avoid arbitrage opportunities?

The risk-weight cap means that F will effectively be 1 for the most senior tranche.

We believe the calibration of the F parameter should be assessed through QIS to ensure it delivers capital outcomes which are not materially different (and certainly not preferential) to the full IRB approach.

14. How prevalent and material are securitisation exposures backed by mixed pools?

We believe that mixed pools would be predominant when we consider all bank parties to securitisations. For example, on any trade, there may be an originating bank, a swap provider and many bank investors.

For banks acting in an investing capacity (as opposed to originators) it is rare that every asset in the pool for the lifetime of the transaction will be eligible for full IRB treatment, either through limitations of data or limitation on the bank’s modelling permissions. Similarly, where a transaction is based predominantly on standardised assets – for example, because the bank does not have permissions covering retail exposure – IRB exposures such as swap receivables may arise from time to time.

Furthermore, even where the reporting firm is the originator, due to AIRB permissions a firm may be forced to choose between the economically ideal pool for securitisation and a less ideal pool which has the benefit of all underlyings being subject to approved AIRB models. The question is also raised as to whether a pool could become mixed due to post securitisation scope changes in the firm’s AIRB permissions.

15. Is the proposed treatment for mixed pools appropriate, or should another approach be employed?

We do not believe that the proposed treatment is appropriate. We are highly supportive of the alternatives recognised by the Committee whereby supervisory estimates or recognised prudent standardised backstops are used in the absence of full IRB data rather than automatically defaulting to the concentration ratio approaches.

We disagree with the proposal to treat resecuritisation exposures exclusively through the concentration ratio approach. A transaction is classified as a resecuritisation where any of the underlying assets, however immaterial, is itself a securitisation exposure. Where the underlying asset pool is dynamic, this presents the possibility that a transaction can move in and out of resecuritisation, producing significant changes in the capital requirement with very little change to the underlying risk profile.

We believe a better approach on resecuritisation would be to look through each layer and apply the relevant credit risk weight framework to each of the assets to determine KIRB. For example, if the assets underlying a resecuritisation were 90% IRB loans and 10% securitisation exposures, the MSFA should be applied to the securitisation exposures individually in order to generate a capital requirement. These capital requirements would then be combined with the requirements for the loans as inputs to an MSFA calculation on the resecuritisation.

We recognise that there are resecuritisations of resecuritisations, with multiple layers, where the bank may be unable to look through to perform all of the necessary MSFA calculations. For any underlying (re)securitisation where the bank is unable to calculate the MSFA, a default risk weight of 1250% could be applied to that item. To return to the previous example, if the MSFA could not be applied to any of the underlying securitisation exposures then the MSFA would be calculated using a 1250% risk weight for 10% of the asset pool and the relevant IRB risk weight for the remainder.

16. Is the definition of maturity appropriate, in light of the Committee's objectives?

We agree that M should be specified on contractual cash flows rather than cash flows which would be modelled using behavioural assumptions for prepayment and other non-contractual factors.

However, we find the definition of maturity in the consultation paper unclear and the default to legal final maturity is detrimental and out of line with both the IRB framework and market practice. The definition of *unconditional contractual cash flows not related to the performance of the underlying assets* is incompatible with the principle of securitisation. Securitisation is defined where the coupon and principle return are conditional on the performance of the assets. This is valid for both synthetic and cash securitisations. Key to risk transfer is that tranches will step down and coupon paid reduces after credit losses impact the tranche. The definition should simply be worded as *unconditional contractual cash flows*.

Otherwise, on retained tranches where equity or junior mezzanine protection is bought using the legal final maturity (to cover some long dated assets in the pool for example) this would increase the maturity horizon for capital purposes just by buying credit protection. We would propose the use of market standard practices for investment tranches and for retained tranches after purchased protection the maturity of the underlying assets so the maturity used is consistent with the IRB calculation for the underlying portfolio.

However, as stated above in comments on MSFA and significant RRBA we have reservations about the way that M is being double counted into the calculations and believe that calibration with regard to M is inappropriately penal.

17. Is the proposed 20% risk weight floor set at an appropriate level? Please provide justification and evidence, to the extent possible, for alternative levels for the risk weight floor.

We would like to better understand the reasons for proposing 20% as a floor – in particular, the evidence that a 7% minimum IRB risk weight has proven inappropriate in all cases. We agree that there is a substantial cliff in the existing framework and that, during the crisis, the capital charge on some positions quickly escalated from 56 basis points to 100%. But the proposals for the MSFA and Revised RBA also seek to address these cliff effects, so there seems to be double-counting. We recognise that model risk is a factor under any approach, including the new proposals, but the imposition of floors and buffers is never a costless option.

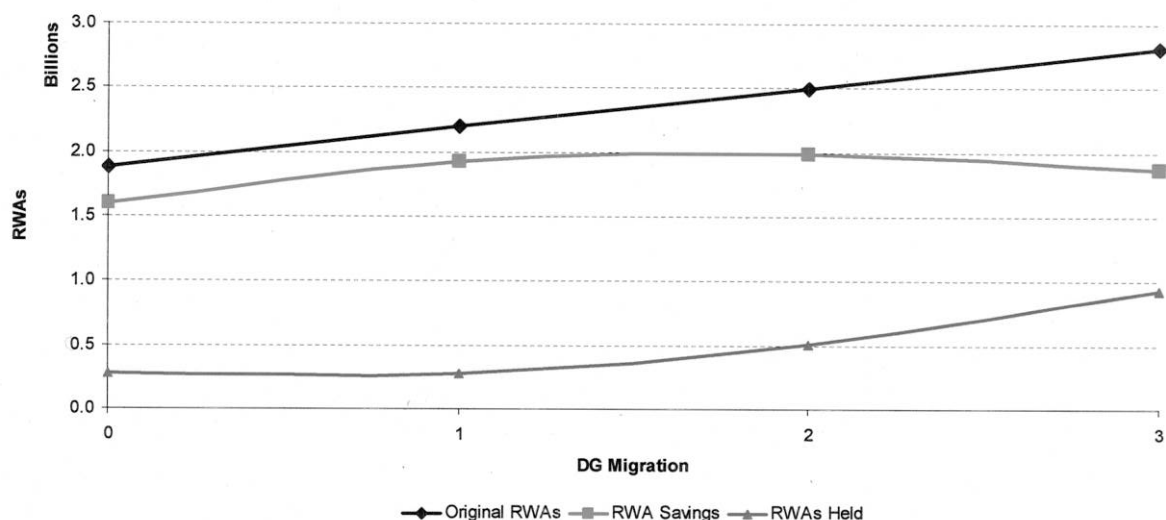
In particular the 20% risk weight floor will be a significant burden on the ABCP business where our experience in our multi-seller conduits would not justify the significant increase in capitalisation suggested by the consultation paper. In the last 20 years we have financed USD248bn of client assets across 702 transactions covering a broad range of underlying asset classes including auto loans, student loans, trade receivables, mortgage servicer advances etc. Over that time we have experienced only two credit losses, one associated with a CDO² and one on credit card advances. Neither transaction would meet the criteria for funding in the conduits now following changes in rating agency methodologies.

Achieving consistency with the existing standardised approach for securitisation does not seem a compelling reason, given the Revised RBA is derived from MSFA, which in turn is based on the IRB approach. This is effectively a trebling of capital requirements for the best quality securitisation exposures which will invariably affect banks' incentives and the overall cost of securitisation as a risk transfer mechanism.

Any floor will be arbitrary to some extent, but we would prefer to see a floor that is comparable to higher-quality assets under the IRB approach (recognising that the Committee is not persuaded that senior tranches are less correlated with other risks). For example, the PD floor of 3bps, a highly conservative LGD of 60% and a maturity floored at 1 year would imply a floor of c.11%.

As a user of securitisation as a hedging instrument (rather than an investor) the cliff effect does not appear for balance sheet transactions as the retained position (say 5-100%) behaves in line with an unhedged portfolio of loans, the absolute amount of RWA increase upon rating migration is the same for a hedged or unhedged portfolio. There is a material increase

on a relative basis but for a balance sheet securitisation the comparison should be made against an unhedged portfolio held on the book.



Comparing the benefit of a hedged versus un-hedged portfolio we have made a comparison between the RWA impact of a portfolio with 0-4% protection in place versus the RWA of an un-hedged portfolio. Since the un-hedged portfolio takes the losses we have added the RWA equivalent of the loss⁵.

For a material but not extreme loss on the portfolio of 2% this leads to a net RWA consumption of about EUR 1.1bn for the hedged pool and EUR 3.2bn for the unhedged transaction. Even post tranche reduction (and the associated less effective hedge) the extra loss capacity of the hedge has protected the bank against material increases in its capital needs. Given the strong performance of many securitised assets pools this demonstrates that for effective risk transfer and loss volatility reduction there is no need for excessively thick tranching.

	Base Case	1% Loss Case hedged	2% Loss Case hedged	2% Loss Case Unhedged
Portfolio Kirb	3.98%	3.86%	3.74%	3.74%
Unhedged RWAs	1,877	1,785	1,686	1,686
Hedged RWAs	280	682	1,095	1,686
RWA Savings	1,597	1,103	592	
Loss Impact (Equivalent RWA)	0	738	1,477	1,477
Hedge Payout (Equivalent RWAs)	0	-738	-1,477	
Net Portfolio RWAs Held	280	682	1,095	3,163

If the floor is intended to be a measure of residual risk, there is an argument that the floor should be derived as a proportion of the average risk weight on the underlying pool. Hence a securitisation of higher quality assets could receive a floor closer to the original 7% and a floor of 20% could be applied to more credit risky assets.

⁵ RWA equivalent defined as net loss time 12.5

18. Should the risk-weight floor for short-term exposures be the same as for long-term exposures?

Yes, in the interests of simplicity.

19. Are the proposed caps and their interactions with the proposed floor risk weight appropriate?

Yes. We would add that limiting the overall cap for SA banks to originators and sponsors is inappropriate in circumstances where there is adequate public disclosure of the underlying assets and losses in the securitisation to allow an accurate calculation of Ks. This will remove another legacy inconsistency between the standardised and advanced approaches to securitisation. Where a bank is an investor and does not have the ability to calculate AIRB risk weights for all underlying exposures it ought to be able to derive a prudent estimate of Kirb using conservative proxies for the other assets.

20. Are there other approaches that could provide a more risk-sensitive treatment while still being prudent and operationally straight-forward to implement?

We agree that using the carrying value of the position is the most practical approach

21. Are the assumptions used in developing and calibrating the approaches discussed above appropriate in view of the Committee's stated objectives? Please provide empirical justification for alternative assumptions to those noted above.

As per our previous comments, it is not clear why the Revised RBA has been calibrated on the assumption of a B-rated corporate pool. We believe that a more appropriate approach would be to use the MSFA with fixed parameters, differentiating between asset classes, where individual asset data is not available. In particular, it is unclear how this assumption maintains consistency with the Basel credit risk framework for retail exposures.

22. Is the proposed treatment of retail securitisations using the same approaches as for corporate securitisations appropriate? Would additional complexity (in the form of an additional formula to adjust the AVCs of retail underlying exposures) be justified to remove the double-counting of maturity effects?

See above for our suggestions on the treatment of retail securitisations.

23. How could concerns that securitised retail exposures have high default risk or high correlation be managed?

A solution here could be to objectively define the pool and transaction characteristics which have to be present (or absent) for the MSFA to deliver a robust result, whether this is with asset-level or pool-level data; transactions that did not conform would not be eligible for MSFA and would need to use the concentration ratio as a fall back method.

24. Is the relative calibration of the approaches appropriate? Please provide empirical data to support conclusions.

We are particularly concerned that the calibration of the RRBA is inappropriate as it assumes that the underlying asset pool is of a poor quality. When the RRBA outputs are compared to MSFA for assets which are not of a poor quality it becomes clear that the RRBA outputs are out of line with MSFA output. See Appendix 2.

As per our previous comment, to respond fully we would need a clearer statement regarding the Committee's objectives in respect of securitisation: if we identify which types of behaviour should be encouraged or discouraged, we can then assess whether the calibration creates the right capital incentives to support these goals.

Appendix 2 – Comparison of the synthetic securitisation of a bank's corporate loan portfolio.

Trade Description

- First loss credit protection closed in May 2011 in the form of CLN
- The trade has a replenishment period and a legal final maturity of 8 years as underlying assets have a weighted average life of circa 3 years.
- Portfolio notional of EUR 6bn and an equity tranche of 5% i.e. EUR 300m
- There is a equity tranche originator retention to align investor and originator incentives.

Moody's rating

- Equity tranche 0-5% : unrated
- Mezzanine Tranche 5-15% : Baa3
- Senior Tranche 15%-20% : Aaa
- Super Senior Tranche 20%-100% : Aaa

Portfolio Statistics

- Portfolio notional EUR6bn
- Number of borrowers 508
- Average internal rating of the pool BBB equivalent

Comparison of approaches

- Existing Basel 2 RBA – RWA saving of approx 60% vs Kirb
- Modified SFA – RWA saving of approx 55% vs Kirb

The Modified SFA is unlikely to be available unless the strict requirement that **all** assets in the reference pool are AIRB. There is a small proportion of standardised assets in the pool.

- Revised RBA – RWA saving of 0% vs Kirb

Under the Revised RBA approach a 0-25% tranche would be required to reduce RWAs from Kirb.