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Mr. Stefan Ingves,
Chairman
Basel Committee on Banking Supervision
Centralbahnplatz 2
Basel, Switzerland

Re: Revisions to the Basel Securitization Framework

Dear Chairman Ingves:

The Institute of International Finance, through its Working Group on Capital Adequacy, is grateful for the opportunity to comment on the Basel Committee on Banking Supervision's (BCBS) consultative document on *Revisions to the Basel Securitization Framework*. We strongly support the goal you stated in your speech on September 13, 2012 (*Regulatory reform: getting it done*) of striking a balance between mitigating the risk posed by securitization and maintaining its function as an important tool for bank funding and liquidity. However, we believe that there are a number of aspects of the proposals that should be reconsidered in order to strike such balance, and importantly, to ensure that prudently managed securitization activities can continue to play important economic roles, including bank funding. Our main concerns in regard to the proposals are the following: :

- In developing new regulatory proposals to address the shortcomings of the current Basel securitization framework highlighted in the last crisis, the BCBS did not seem to take sufficiently into account subsequent structural progress made by market participants in securitization (e.g. stricter origination standards, more robust structures, greater disclosures, improvements in ratings methodology, the Prime Collateralized Securities and similar initiatives addressing deal quality, increased ratings regulation, etc.). These changes have already addressed, at least partly, the factors underlying the identified shortcomings of the current Basel securitization framework.

- The calibration of the proposed approaches does not reflect the quality and performance of the underlying assets. It requires significantly more capital to hold securitized assets compared to the holding the same underlying assets directly, which will certainly eliminate banks' economic incentive to use securitization. The prudential objective for such treatment has not been clearly articulated or justified in the proposals.

- The proposed risk weight floor is detached from the credit performance history of the underlying assets. This disconnect in calibration would certainly create perverse incentives (e.g. banks focusing on low-quality exposures to ensure a proper return is earned on the required capital).

- All of the above contribute to the undue conservatism in the proposed revisions. This is further

compounded by the introduction of the maturity adjustment, including its strict definition, derecognition of risk transfer associated with certain structures with early amortization trigger, and the conservatively set p factor of the Simplified Supervisory Formula Approach (SSFA).

- This undue conservatism also does not seem to consider the changes made to the overall Basel framework and other aspects of the international regulatory reform program framed by the G20. Basel III has increased the quantity and improved the quality of required capital, has included a number of capital buffers, has introduced the leverage ratio, and has established liquidity ratios that do not treat securitization exposures favorably. Hence, viewed alongside all these changes, the proposed revisions will put significant pressure on the securitization market, reducing the availability of an important source of funding and liquidity for the real economy.

- Lastly, the proposal lacks sufficient clarity in terms of implementation and timing, increasing the uncertainty around firms' funding plans and needs.

Below we offer detailed comments on the consultative document. Our general comments immediately follow, while comments on the main sections of the consultative document are discussed immediately after.

General comments

Regulatory coordination

The IIF is concerned that the proposed revisions to the BCBS securitization framework may not have been adequately coordinated with other related regulatory initiatives. For example, there is the broader work of the Financial Stability Board (FSB) on shadow banking, which includes a specific work stream on securitization. The output of this work stream is the International Organization of Securities Commissions (IOSCO) final recommendations on securitization (*Global Developments in Securitization Regulation*, November 2012). While we understand that there is different focus of the IOSCO and the Basel work streams on securitization – the former focused on assessing and aligning incentives associated with securitization (e.g. through the use of risk retention rules) while the latter focused on the calculation of capital requirements for banks' securitization exposures – there is likely to be overlap given that capital requirements can influence banks' incentives to serve their various roles in securitization transactions (e.g. as originator, sponsor, investor, liquidity provider, etc.). As the Joint Forum's *Report on Asset Securitization Incentives* (July 2011) noted: "…more coordination across different regulatory authorities is required to avoid a scenario of rules being adopted in different contexts…the interaction of those risk retention regulations with regulatory capital requirements…may deserve consideration."

It may be the case that there was coordination between the BCBS and IOSCO on this issue, but it should be made clear by making reference to it in the paper and by discussing the measures taken to make sure that there are no overlaps or duplication in the risks or issues addressed by the IOSCO recommendations and the BCBS rules. It would also be helpful if there were a strategic

statement of what both bodies of regulation are aiming to achieve, from the microprudential, macroprudential, and macroeconomic viewpoints.

As the IIF pointed out when the enhancements to Basel II, which focused mainly on securitization, came out, the capital rules for securitization must be evaluated and coordinated with all other improvements being proposed for the securitization process by different authorities (e.g., new ratings requirements; greater transparency; etc.)[1].

Securitization in the trading book

Another example of what seems to be lack of sufficient coordination was the reference made to the BCBS's fundamental review of the trading book (FRTB). The last paragraph of page 34 of the proposals noted that there were no proposed revisions to the trading book treatment of securitization exposures because the FRTB was currently under way. We would like to get clarity on whether the second consultative document on the FRTB will include specific proposals for treatment of trading book securitization exposures since these were not covered in the first consultation.

We would have preferred that this consultation (and the planned QIS) also included the treatment of securitizations in the trading book. Given the tasks already assigned to the FRTB, and the uncertainty of timing of that exercise, we feel it would have been better to consider specific trading book issues as part of this consultation, which could then be fed back into the FRTB discussion as necessary.

While it may be the intention to effectively stop securitizations and resecuritizations from being held in the trading book, it needs to be recognized that doing so would run against the wider statements of the usefulness of securitizations for economic activity. If there is an economic reason for supporting securitization activities (such as articulated by the G-20, FSB and BCBS, and more recently by the ECB[2]), there will also be a need for market making to support liquidity in secondary markets. It would be therefore counterproductive to undermine the holding of almost all securitizations in the trading book as by definition market making activities will be in the trading book.

It will also be appropriate for firms to hold some securitization issues in trading categories for accounting purposes, depending on the business model that applies, and there should be no conflicting incentives between prudential and accounting requirements on this point.

Among the difficulties the current proposals create are that they do not recognize partial hedges. We think these do need to be recognized to support risk mitigating activities when holding securitizations for market making activities. We would therefore encourage the BCBS to discuss

[1] IIF letter to the BCBS dated April 23, 2009

[2] Joint Forum's Report on Asset Securitization Incentives, July 2011
Regulatory reform: getting it done, speech by Stefan Ingves, September 13, 2012
Transition of the financial system in the wake of the financial crisis, speech by Peter Praet, February 12, 2013

with industry how the proposed approaches could be expanded to incorporate at least some hedging.

We also feel that insufficient clarity has been provided on how the various approaches proposed in the consultation would work for short positions.

Unduly conservative calibration

The proposed revisions to the securitization framework have been calibrated in an unduly and unnecessarily conservative manner, even taking into account the BCBS's objectives behind the proposals as we understand them. The resulting capital charge does not reflect experience during the crisis or the improvements in the securitization market made after the crisis. As noted by a Fitch Ratings report (*Global Structured Finance Losses*, October 2012), the poor performance of securitized assets was not widespread to all asset classes. The report noted, for example, that ABS transactions particularly those secured by consumer assets (credit card receivables, auto loans, student loans) have been resilient to the crisis. In addition, the report found that 99% of global structured finance losses can be attributed to transactions issued before 2008 despite representing only 78% of total covered issuances. The minimal losses on newer issuances "reflect the higher credit quality of collateral portfolios and increased credit protection provided by transaction structures[3]."

Given the actual losses presented in the Fitch Ratings report, the calibration of the BCBS proposals seems to over-state the credit loss for a number of consumer sectors and commercial assets which comprise the majority of current ABS issuance. A securitization framework that does not take into account the quality and performance of the underlying assets will not only be risk insensitive but will also risk shutting down or severely limiting the potential of the securitization market, thereby potentially removing valuable funding diversity for banks and for corporates accessing this funding tool through ABCP programs since it lumps all securitization into the riskiest category.

Implementation

The consultative document should make clear the planned implementation timeline and set an appropriate transition period, keeping in mind the need to balance new regulatory measures against the ability of the existing securitization market to provide funding. Since the securitization market is fundamental to the funding of certain institutions, and more widely to the economic recovery, it is important to remove uncertainty around the implementation of the proposals. Indeed, as the Joint Forum's Report stated: "…uncertainty about the direction, timing and implementation of regulatory proposals is currently a significant impediment to reviving the securitization market.[4]"

It is also highly important that an appropriate adjustment for legacy instruments and a transition period for new issuances should be included in the BCBS final rules.

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[3] Page 1 of Fitch Ratings report: *Global Structured Finance Losses,* October 2012
[4] Page 25 of the Joint Forum's *Report on Asset Securitization Incentives,* July 2011

Given the significant increase in capital requirements that would result from the proposals (especially if the BCBS would implement the proposals as currently formulated) and the practical implementation challenges of applying the new rules to existing instruments (e.g. the proposed dual rating requirement), prospective and not retrospective application of the revisions is necessary to avoid cliff-effects in capital requirements and further instability in the securitization market. With respect to existing instruments, it needs to be kept in mind that securitization are closed transactions that are very difficult to modify from a legal point of view. Therefore, it is unlikely than many (if any) transactions could be adjusted to the new rules. This in turn would make it very unattractive for banks to continue to hold such transactions, resulting in incentives to dispose of them, perhaps at fire-sale prices, as rapidly as possible, given the capital impacts they would have.

Similarly, an appropriate phase-in period to allow the market to understand and adjust to the new rules is highly advisable in order to avoid disruption. An orderly phase-in period would allow banks to adjust their procedures and structures, permit well-considered adjustments to documentation, and assure investors that they understand the implications of the new regime.

Motivations for revising the securitization framework

The consultative document identified the four shortcomings of the current Basel securitization framework that are intended to be addressed by the proposals. These are (1) mechanistic reliance on external ratings, (2) too low risk weights for highly-rated securitization exposures, (3) too high risk weights for low-rated senior securitization exposures, and (4) cliff-effects in capital requirements following deterioration in credit quality of the underlying pool.

The IIF supports the overall goal of addressing the shortcomings of the current Basel securitization framework. However, in addressing these shortcomings, the BCBS should also take into account changes in the securitization market that may have already addressed, at least partly, the factors underlying some of these shortcomings.

These changes include regulations that align originator/sponsor incentives with those of investors through risk retention requirements, greater disclosures to investors, improvements in origination standards, transaction structures, ratings methodology, etc. For example, greater disclosures to investors should lead to less reliance on external ratings. Also, improvements in ratings methodology combined with improvements in origination standards and structural features should reduce the chances that securitization exposures would suffer significant ratings downgrade in a stressed period, as happened during the last crisis, thereby reducing the cliff effects. Furthermore, many jurisdictions have incorporated due diligence requirements in their implementation of the Basel 2.5 and Basel III rules. These requirements reduce banks' reliance on external credit ratings, and require them to demonstrate a comprehensive understanding of the securitization risks they enter by thoroughly assessing and documenting the risk characteristics of their securitization exposures. These requirements effectively require banks to have a more detailed understanding of their securitization risks, which will likely reduce the severity and the frequency of losses.

Failing to account for these changes, as appears to be the case in the present proposal, would surely result in failing to reflect in a reasonable way the actual risks of the transactions. The effect of accepting the current version would be that capital requirements would be calibrated to reflect the risks inherent in securitization markets of the past but which have already been addressed. This, coupled with Solvency II, which constrains insurance companies' ability and willingness to invest in securitization, would seriously bring into question the viability of the securitization market. This is inconsistent with the BCBS's statement that there is a balance to be made between mitigating the risk posed by securitization and maintaining its function as an important tool for bank funding and liquidity (*Regulatory reform: getting it done*, speech by Stefan Ingves, September 13, 2012). This is also inconsistent with the high-priority goal of the G-20 and the FSB of re-establishing sustainable securitization markets "in order to support provision of credit to the real economy and improve banks' access to funding in many jurisdictions" (Joint Forum's *Report on Asset Securitization Incentives*, July 2011).

Considerations around the hierarchy of approaches

The consultative document offers two alternatives for a possible hierarchy of approaches – alternative A and alternative B. Assuming that the unduly conservative calibration of the approaches is addressed, many members think alternative A offers less disadvantages than alternative B, and that the disadvantages of alternative A would be more easily addressed.

As noted in the consultative document, since the modified supervisory formula approach (MSFA) would be at the top of the hierarchy, banks would be encouraged to perform internal assessments of risk rather than mechanistically relying on external ratings. However, as recognized in BCBS Working Paper No. 22(*Foundations of the Proposed Modified Supervisory Formula Approach*, January 2013), there is room to simplify the MSFA framework in order to reduce its information requirements on banks by allowing proxies to be used as inputs in the MSFA in appropriate circumstances (which could be subject if necessary to supervisory approval). Allowance for a degree of additional flexibility in using the very prescriptive MSFA would make it much more readily available to banks, especially with respect to third-party assets.

The revised ratings-based approach (RRBA) and SSFA should also be closely aligned to reduce divergences in capital requirements across jurisdictions. As noted in the consultative document, alternative A allows national discretion on whether to use the RRBA or the SSFA for banks that do not qualify for or are not able to use the MSFA. Without closely aligning the capital requirements resulting from the RRBA and SSFA, this could result in substantially different capital requirements across jurisdictions for similar exposures, resulting in level playing field issues – a scenario that the current BCBS review of risk weighted assets (RWA) comparability tries to address.

Alternative B, on the other hand, is inconsistent with the stated goals of the securitization proposals. The pros and cons discussion for alternative B (page 11) highlights the same concerns we have. First, there is danger that alternative B would lead to reliance on external ratings in determining high-quality senior securitization exposures. Second, by differentiating the treatment

between high-quality senior securitization exposures and other securitization exposures, there would likely be a big gap in the capital requirements of the two types of exposures, which would unduly penalize subordinated tranches and non-high quality senior exposures. This gap would lead to cliff effects if a senior high-quality senior securitization exposure experiences a rating downgrade especially under stressed market conditions. All of these things are the same shortcomings of the current Basel securitization framework, which the proposals are supposed to address.

In addition, if external credit ratings became the de facto determinant of high-quality senior securitization exposures under alternative B, this would significantly limit securitization issuances in emerging markets (and would also result in a totally different framework for assessing "high-quality" in countries such as the US, where references to credit ratings in regulations have been removed). Credit rating agencies typically link the rating of ABS/RMBS/structured finance products with sovereign ratings of the countries of issuance, which limits those products' maximum achievable ratings (to certain notches above the sovereign rating). This cap makes it impossible for structured products in many countries to obtain certain ratings such as AAA or AA-, specifically for emerging and European peripheral countries. Thus, if high-quality senior securitization exposures are limited to those that are AAA rated, it will likely prevent structured finance from developing in emerging markets and constrain funding alternatives in these markets.

Proposed approaches in the securitization framework

As the consultative document notes, the proposed revisions will likely increase the capital requirements for securitization. While some increase is expected and appropriate, analysis shows that the results would substantially overshoot what strictly risk-based standards would require and does not seem to strike the right balance between mitigating the risk of securitization and maintaining its function as an important tool for bank funding and liquidity.

Requiring far more capital to hold securitised assets compared to the underlying assets would eliminate banks' economic incentive to use this tool for most purposes. A bank holding a portfolio of loans (mortgages for example) will obtain a certain return from these assets remunerating the amount of necessary regulatory capital. If that bank securitizes this portfolio to sell the senior tranche to a group of banks (note that the senior tranche could as well be sold to other investors, but for this example, we used bank buyers to illustrate the point of significant difference in capital requirements between the securitized and the unsecuritized form of assets), it is necessary to compare the initial regulatory capital with the total capital that both the seller (junior tranche holder) and the bank buyers (senior tranche holders) will need. If that total is much higher, it means that the economic return of the same loan assets will have been much reduced once they're securitized.

To make a realistic comparison, we can assume that the seller uses the advanced internal ratings-based (AIRB) methodology for its loan assets and the SFA/MSFA method for the junior tranche after the securitization. The senior tranche buyers, on the other hand, will most likely be banks that rely on the RBA/RRBA methodology since a rating is necessary to place these tranches and the buyers have not originated the loans and may not have access to the loan-level information

required to use the MSFA (or such information may not be in the form required to apply the highly prescriptive MSFA).

Table 1

5y	Initial RWA (PD = 0.50%, LGD = 15%)	[0-20%] Jr Tranche Risk Weight x Tranche Size (20%)		[20-100%] AAA Tranche Risk Weight x Tranche Size (80%)		Risk Weight of Total Securitization Capital Structure		Increase in Risk Weight relative to Initial RWA	
		SFA	MSFA	RBA	RRBA	Current	Proposed	Current	Proposed
Without cap	35%	42%	58%	6%	46%	48%	104%	x1.4	x3.0
With cap	35%	35%	35%	6%	46%	41%	81%	x1.2	x2.3

We can see in Table 1 above that the current regulatory framework includes a penalty for securitization, presumably designed to deter arbitrage. Despite this penalty, securitization still makes sense in a number of cases due to the benefits it procures to seller and buyer. But, with regulatory capital tripled (or doubled if you apply the regulatory cap on the originator), and economic return more than halved, it puts into question whether this tool will still remain economically viable to provide financing to, say, mortgage originators.

Table 2 below provides another example, this time based on a real credit card securitization transaction (a 4-year maturity was assumed, based on a 3-year revolving period and 1-year amortizing period). Required capital is calculated under the different proposed approaches. Again, the proposed new approaches result in capital charge that is way above the capital charge for the underlying pool (as much as 3 times under the SSFA).

Table 2

Tranche	Notional ($MM)	External rating	Required Capital ($MM)			
			If not securitized (PD = 1.02%, LGD = 98%)	Hierarchy B (Revised RBA for senior; Concentration Ratio for others)	MSFA	SSFA
Senior	94.5	AAA	-	3.5	8.2	9.5
Mezzanine	2	AA	-	2	2	2
Subordinated	3.5	BBB	-	3.5	3.5	3.5
Total	100		4.6	9	13.7	15
*Does not include the impact of the Kirb cap						

One key characteristic of credit card transactions is the use of excess spread, which provides a first loss protection to investors. However, excess spread is not taken into account in either the current or the proposed revised securitization framework (with the exception of the rating based approaches since rating agencies recognize the credit enhancement offered by excess spread; hence creating yet another discrepancy in approaches) despite evidence of its effectiveness in providing protection for some asset classes. For example, according to the Fitch Ratings report on *Global Structured Finance Losses* (October 2012), there are no losses on credit card ABS in the US because excess spread offset the unprecedented delinquencies and charge-offs. Again, this points to the

importance of looking at the quality and performance of the underlying assets to make a more risk sensitive securitization framework.

Revised Ratings-Based Approach (RRBA)

Comparing risk weights of similarly rated unsecuritized assets and tranches of securitized assets shows that the risk weights under the RRBA for securitized assets are significantly higher than those for unsecuritized assets (Tables 3). For securitization exposures with longer maturities, for example five years, it is important to remember that rating agencies do take into account the fact that such exposures will have higher probability of experiencing credit losses within the five-year horizon (as opposed to one-year) and therefore require more conservative tranching to achieve identical rating levels. It does not make sense to compare identically rated five-year loan assets (where the higher RWA is necessary to reflect the greater potential to incur credit losses due to the longer maturity) with five-year portfolio tranches, where the higher risk of losses have led to more conservative tranching. This does not seem to have been taken into account in the RRBA.

Table 3

1y	Unsecuritized assets RWA (using AIRB, S&P PDs, 35% LGD)	Securitized assets RWA under RRBA	Securitized RWA/ Unsecuritized RWA
AAA	6%	20%	x3.3
AA	6%	51%	x8.5
A	13%	81%	x6.2
BBB	28%	118%	x4.2
BB	58%	170%	x2.9

In its Working Paper No. 23: *The Proposed Revised Ratings-Based Approach* (January 2013), the BCBS notes that "in light of recent enhancements to rating processes, the rating model developed herein is not tied to the performance of securitization ratings during the financial crisis.[5]" However, despite these enhancements and the improvements in the securitization market noted earlier, the proposed revisions nevertheless prescribe capital requirements that imply larger losses than experienced during the crisis at least for many asset classes (see for empirical example the Fitch Ratings report on *Global Structured Finance Losses*, October 2012). This conservatism arises from the conservative assumptions used by BCBS in calibrating RRBA. Specifically, as mentioned in its Working Paper No. 23 (*The Proposed Revised Ratings-Based Approach*, January 2013), the calibration of a AAA tranche capital requirement is based on the assumption that the underlying pool has a PD equivalent a B-rated corporate bond (PD = 4.729%) and a very high LGD (60%). These assumptions are very unrealistic in light of member banks' experience, and seem to have been

[5] Page 6 of BCBS Working Paper No. 23: *The Proposed Revised Ratings-Based Approach*, January 2013

chosen to come up with a predetermined number rather than to reflect the actual riskiness of transactions.

Given the enhancements in the rating processes recognized by BCBS Working Paper No. 23 as mentioned above, as well as other improvements in the securitization market, the rational expectation would have been that they would lead to ratings that would fully reflect the risk of the securitization exposure, and thus the expected losses would have been smaller relative to the crisis. As the Fitch Ratings report pointed out, post-crisis structured finance transactions have lower losses because of a number of mitigating factors including "significant tightening of banks' origination criteria, more robust transaction structures, and the minimal issuance of transaction types with weaker performance during the crisis.[6]" The BCBS should take these factors into account.

Below is another example that shows how the RRBA can significantly increase capital requirements even for securitization structures with very high quality underlying assets.

The transaction is a securitization of auto loans for financing purposes. Within the structure, only the senior tranche (tranche A) is rated and sold to investors. There is no capital relief associated with this transaction, but we can compare the RWA associated with the portfolio before securitization with the RWA of the total securitized exposures. The K_{IRB} of the underlying portfolio is 1.78% and its average RW is 22.3%. The maturity of the transaction is 2.8 years. Under the current framework, the RBA applies for the senior tranche that is rated while the SFA applies for the others. The current framework results in an average risk weight of 30%, which is already higher than that of the underlying portfolio (Table 4).

Table 4

	Rating	Approach	Tranche size	RW	RW x Tranche size
Senior	AAA	RBA	79.5	7%	5.6%
Mezzanine	NR	SFA	20.5	29%	6.0%
Equity (funded)	NR	SFA	1.5	1250%	18.8%
				Average RW:	30.3%

Using the proposed alternative B hierarchy, we applied the RRBA for the senior rated tranche and the Concentration Ratio based on K_{IRB} for the other tranches. The average risk weight increased further to 68.2% (Table 5). Hence, while the underlying portfolio is of high quality, the application of the proposed changes to the securitization framework resulted in a capital charge for the whole securitization structure that is three times higher than that of the underlying portfolio.

[6] Page 3 of Fitch Ratings report: *Global Structured Finance Losses,* October 2012

Table 5

	Rating	Approach	Tranche size	RW	RW x Tranche size
Senior	AAA	RRBA	79.5	36%	28.7%
Mezzanine	NR	CR_KIRB	20.5	101%	20.8%
Equity (funded)	NR	CR_KIRB	1.5	1250%	18.8%
				Average RW	68.2%

Another issue that concerns us is the proposed requirement of two ratings under the RRBA. Obtaining a second rating would not be applicable for most existing structures, for which seeking additional rating is no longer possible. Looking forward, the dual-rating requirement is also likely to be an issue in some jurisdictions, particularly emerging market jurisdictions, where ratings accessibility may not be fully developed. Ironically, for most of these jurisdictions, only the RRBA would seem to be the more feasible approach. However, the dual rating requirement will hinder the use of RRBA by banks in these jurisdictions, pushing them instead to the most conservative backstop approach, which in turn will hinder the development of securitization as a financing tool and of markets in such countries. Hence, we urge the BCBS not to push ahead with the dual-rating requirement.

Modified Supervisory Formula Approach (MSFA)

The main change in the MSFA is the introduction of the maturity adjustment, which has quite a significant impact on the required level of subordination. The example below of securitization of SME loans, which is based on a real transaction, illustrates this.

The example shows the securitization of a granular portfolio of SME loans with a 5-year maturity. The three tranches (equity, mezzanine, senior) are not rated by rating agencies and the regulatory capital is computed using the current SFA. Capital relief is achieved by selling 95% of the mezzanine tranche to an investor, the rest is held by the originator. The K_{IRB} of the portfolio is 5.9% (EL = 0.3%, UL = 5.6%) and its average RW is 70%. Table 6 shows that the average RW after securitization is 51.92% and the risk transfer is 30% (i.e. RWA of the transferred position).

Table 6

	Attachment point	Detachment point	RW SFA	Retention (%)	RW SFA originator (RWA SFA x Retention)	RW SFA originator x tranche size
Senior	6.1%	100%	7%	100%	7%	6.57%
Mezzanine	3.5%	6.1%	1232%	5%	62%	1.60%
Equity	0%	3.5%	1250%	100%	1250%	43.75%
					Average RW:	51.92%

Following the application of the MSFA, the average RW is 124.25% (Table 7). The impact is quite significant because of the low attachment point of the senior tranche that is just above K_{IRB}. While this risk weight will not apply to the originator because of the regulatory cap equal to the original risk weight of the underlying assets, this still means that the originator will not have capital relief from the securitization transaction, which would influence an originator's incentive to undertake the transaction in the first place. In this particular case, the attachment point would have to be raised to 16% instead of 6.1% in order to achieve capital relief under the MSFA (Table 8).

Table 7

	Attachment point	Detachment point	RW MSFA	Retention (%)	RW MSFA originator (RWA MSFA x Retention)	RW MSFA originator x tranche size
Senior	6.1%	100.0%	84%	100%	84%	78.88%
Mezzanine	3.5%	6.1%	1247%	5%	62%	1.62%
Equity	0%	3.5%	1250%	100%	1250%	43.75%
					Average RW:	124.25%

Table 8

	Attachment point	Detachment point	RW MSFA	Retention (%)	RW MSFA originator (RWA MSFA x Retention)	RW MSFA originator x tranche size
Senior	16.0%	100.0%	20%	100%	20%	16.80%
Mezzanine	3.5%	16.0%	768%	5%	38%	4.80%
Equity	0%	3.5%	1250%	100%	1250%	43.75%
					Average RW:	65.35%

We have examined the impact of maturity adjustment on the risk weight of the senior tranche for different attachment points, assuming a K_{IRB} of 5.9% (Table 9). Our conclusion is that for securitization transactions with maturities from three to five years, the attachment point of the senior tranche has to be two to three times higher than the K_{IRB} for the tranche to be able to benefit from the minimum risk weight of 20%. While this may be an intended effect to some extent, this seems quite excessive and should be reexamined given the improvements in the securitization market and other bodies of regulation.

Table 9

Attachement point senior tranche	RW senior if M=1	RW senior if M=2	RW senior if M=3	RW senior if M=4	RW senior if M=5
5%	26%	41%	59%	78%	97%
6%	20%	29%	46%	65%	85%
7%	20%	20%	37%	55%	74%
8%	20%	20%	29%	46%	65%
9%	20%	20%	24%	39%	56%
10%	20%	20%	20%	33%	49%
11%	20%	20%	20%	27%	42%
12%	20%	20%	20%	22%	36%
13%	20%	20%	20%	20%	30%
14%	20%	20%	20%	20%	26%
15%	20%	20%	20%	20%	21%
16%	20%	20%	20%	20%	20%
17%	20%	20%	20%	20%	20%
18%	20%	20%	20%	20%	20%
19%	20%	20%	20%	20%	20%
20%	20%	20%	20%	20%	20%

Simplified Supervisory Formula Approach (SSFA)

For the SSFA, we show an example of how securitization is used by a company in a non-financial industry to generate capital at attractive price levels and how the new proposals will affect such industries. The example below specifically shows that the assumed p factor contributed to the undue conservatism in the capital requirement.

The example is based on a real transaction issued by Volkswagen (VW). VW auto lease ABS transactions date back to as long as 1996 and always, even during the crisis, performed well and have always had higher investor demand.

The pool mainly consists of leases against unrated corporates (SME) with a small portion of retail exposures. Under the SA, the pool therefore has a relatively high risk weight of 99.98%. The tranching is chosen in a way that a AAA rating for senior and a A+ for the mezzanine tranches can be achieved. Given the good performance of the series during the crisis there is no reason to criticize this methodology.

Applying the new SSFA proposed by the BCBS (with a factor of p = 1.5) the senior tranche receives a risk weight of 160% (Table 10) which is a) much higher than the pool risk weight, and b) leads to a total capital consumption of the senior tranche that is higher than the current SA RWA for the whole pool.

Table 10

	Attachment point	Detachment point	RW SSFA (BCBS p = 1.5)	RW SSFA with cap	RW SSFA (U.S. p = 0.5)
Senior	8.2%	100.0%	160.3%	99.9%	51.6%
Mezzanine	5.4%	8.2%	1249.2%	1249.2%	1247.6%
Equity	0%	5.4%	1250%	1250%	1250%

The fact that a position with significant credit enhancement (and which has proven to have worked even during the crisis) has to be capped to the underlying pool risk weight puts into question the calibration of the SSFA. This is in particular true when compared to the current U.S. calibration of the SSFA (with a factor of p = 0.5), which leads to a risk weight of the senior tranche that is significantly lower than the underlying pool. It is unclear why a significantly more conservative calibration has been chosen.

Our analysis indicates that for a senior position to receive a risk weight lower than the underlying pool, there has to be at least 15% of credit enhancement. Again, this is quite excessive given that this is almost double the amount demanded by rating agencies for a AAA rating, and yet it achieves only a very minimal capital relief (Table 11).

Table 11

	Attachment point	Detachment point	RW SSFA (BCBS p = 1.5)	RW SSFA with cap	RW SSFA (U.S. p = 0.5)
Senior	15.0%	100.0%	98.2%	98.2%	20.0%
Mezzanine	5.4%	15.0%	1028.4%	1028.4%	767.6%
Equity	0%	5.4%	1250%	1250%	1250%

Under the current securitization framework, senior and mezzanine tranches both achieve risk weights below the proposed floor of 20%, making it an attractive investment for financial institutions and resulting in low spreads for VW. Under the proposed revisions, depending on the jurisdiction's choice in Alternative A, the new capital consumption would increase by factors 8 to 13 for the senior tranche and by factors 20 to above 50 for the mezzanine tranche (Table 12). As a consequence, spreads for VW would have to rise or it would have to use other more expensive forms of funding.

Table 12

	Rating	RW RBA	RW RRBA	RW SSFA	RRBA/RBA	SSFA/RBA
Senior	AAA	7.0%	58.0%	98.2%	x8.3	x13.2
Mezzanine	A+	18.0%	362.3%	1028.4%	x20	x53.9
Equity	NR	1250.0%	1250.0%	1250.0%	x1	x1

Note that we used the legal maturity here (capped to 5 years) since the expected economic maturity (around 2.5 years) cannot be used for calculating capital requirements due to the fact that the contractual payments are "dependent from the actual performance of the securitized assets" (page 30 of the consultative document). If the economic maturity were used, the RRBA would generate risk weights of 33% and 235% for the senior and mezzanine tranches, respectively. This leads to lower but still high capital numbers.

Other proposed changes and clarifications

Resecuritization

Given that all resecuritizations are all lumped into the most conservative backstop approach without discrimination, what would be considered as resecuritization should be clarified. The current definition purposely includes securitization of pools of underlying ABS that can be difficult to analyze owing to wide range of possible assets and uncertain correlation assumptions (e.g. CDOs of ABS, CDO squared, etc.), reflecting experience with complex securitizations in the crisis and certain "false" securitizations that purported to transfer risk to investors but had mechanisms that returned a large portion of that risk back to originating bank.

However, the definition is so broad that it also captures many innocuous securities and ignores their significant credit support.

A simple example would be a retranching of a single securitization exposure. These transactions have provided a solution to the cliff effect in the current securitization rules when ratings decline and are no different from re-rating the underlying ABS transaction. Mechanically, these transactions simply wrap existing transactions in new legal documentation, without changing the nature or risks of the underlying assets. This approach achieves by a simple practical expedient a restructuring of the original transaction that cannot as a practical matter be achieved by revising the original, closed transaction, segregating deteriorated exposures that caused a rating downgrade of the original transaction from performing exposures and allowing a re-rating of the better tranche(s) on normal principles. Serious thought must be given on whether these types of transactions, which as mentioned above have provided solution to cliff effect in the current framework, should be treated as resecuritizations.

Another example would be CLO transactions that often have small buckets to hold securitization positions rather than loans. Typically, this bucket is 5% or less of the transaction at launch, which is significantly less than the over-collateralization of the senior tranches. Since even a single securitization position in the underlying is enough to taint the transaction as a resecuritization, these CLO transactions would be treated as such and subject to a very conservative capital requirement not in line with their actual risk characteristics. While new CLOs can be structured without ABS assets, existing CLOs cannot practicably be amended to remove their existing securitization holdings. If the proposed rules were to be implemented as formulated, the capital effect would drive banks to liquidate their affected holdings, which could significantly disrupt the CLO market. Appropriate adjustments for these existing holdings should therefore be considered in

the final rules. In addition, we urge the BCBS to either consider establishing a threshold on the percentage of securitization assets in the underlying pool before a structure is treated as a resecuritization, or consider the proposed approach discussed below of allowing banks to write-down the portion of the underlying pool that is securitized (other industry associations or individual firms may have other similar proposals, which we hope the BCBS will also consider).

Mixed Pools

The proposals mention securitization exposures backed by mixed pools in the context of proposals concerning the backstop concentration ratio approach (BCRA)[7]. It seems the BCBS assumes that mixed pools are very unusual. In practice, however, most securitization exposures are backed by mixed pools (particularly pools of SA and IRB exposures). The question of how to treat mixed pools is therefore material. The BCBS should reconsider its proposal for mixed underlying pools. There is no need to limit the permitted approach to the conservative BCRA. Alternatives might include (i) the right to use the SSFA for the whole underlying pool or (ii) in the case of underlying pools of securitization and non-securitization exposures, an approach that allows banks to write-down the portion of the mixed pool that is securitized .

Under the second alternative just stated, if a bank has a resecuritization exposure whereby the underlying pool is made up partially of loans and partially of securitizations, the bank would "write-down" the value of the securitizations in the underlying pool to 0. The remaining pool would then be subject to the appropriate securitization hierarchy rather than the BCRA.

Consider the simple example of a $100 securitization where 10% of the underlying assets are securitizations (i.e. it constitutes resecuritization to that extent). Under the proposed approach, the 10% of the underlying assets that are securitizations would be written down and the tranches would be re-sized to reflect the write-down. Since the remaining underlying assets are all non-securitizations, banks would use the regular securitization hierarchy.

The benefits of such an approach are several. For one, it better aligns the regulatory capital requirements with the underlying risks. Consider the example of two CLO deals, A and B. Deal B is identical in all respects to Deal A (both securitize $100 million of assets) except that Deal B also owns a re-securitized asset (excess collateral) with $10mm market value. Deal B unequivocally offers investors better (or at worst equal) cashflows, more diversification, and better credit enhancement than Deal A (because of the excess collateral assets). However, the proposed different capital treatment of the two deals (with Deal B subject to BCRA) may create the perverse incentive to prefer Deal A to Deal B, even though Deal B provides better returns at lower risk. In contrast, if banks were instead to carry the re-securitized asset at zero market value and apply the securitization hierarchy, both deals would receive the same capital treatment, thereby ensuring the alignment of capital and risk. Note that accepting a zero market value is of course conceptually not correct because resecuritization assets have value; however, the zero-value approach offers a simple and

[7] Page 29 of the consultative document

pragmatic way of dealing with the incremental risk while correcting the effect of the present proposal to taint the entire deal because of a small proportion of underlying securitization assets[8].

Another benefit of the proposed alternative from a prudential point of view is that it is a conservative measure. While perhaps not as conservative as the BCRA, writing down the underlying securitized assets reduces the credit enhancement for all tranches. This will therefore increase the capital requirements under the MSFA or SSFA for all tranches while still incorporating any residual credit enhancement into the capital requirements, without the unintended and perverse effect of penalizing over-collateralization. The proposed alternative is therefore both a conservative and risk-sensitive measure.

Finally, this proposed alternative does not require yet another new and separate approach for securitization exposures. Rather, it leverages existing methodologies to arrive at a more sensible outcome. Therefore, our proposed alternative should be relatively simple to implement consistently across all banks and all regions, which is critical to ensure a level playing field.

Maturity

As noted above, rating agencies already consider maturity of a securitization in determining the tranching level required to achieve a certain rating. In addition, maturity is also taken into account in computing for the IRB capital requirement of the underlying exposures, which is the basis for the MSFA capital charge. The BCBS should take this into account in its calibration to avoid double counting of the same risks, which will obviously lead to higher capital requirement.

The definition of the maturity is much too conservative. Generally, it makes sense to define the maturity of a transaction similarly to the definition currently used in the wholesale IRB framework. However, banks should be allowed to calculate the maturity based on the weighted-average maturity of the cash flows of the tranche in all cases so that it would better reflect the expected duration of the risk exposure. Contractual payments that are unconditional and not dependent on actual performance of the securitized assets contradict characteristics of typical ABS transaction. If the regulations would remain as proposed, in most cases the legal maturity or the cap would be applied, which would increase the capital requirements further (as illustrated in Table 12 above).

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[8] A real-world example is the 11 – 17% BBB tranche of CARLYLE9 CLO (CUSIP 14309BAG9), a deal which has 2.8% of securitized assets. The first dollar principal loss for the BBB occurs at 18.5% annual default rates. The attachment point of this tranche is 11.0%, the detachment point is 17.3%, and the KSA is 8.9%. Therefore, this tranche would attract a capital requirement of 100% under the BCRA. However, if the 2.8% of securitized assets were written down to zero (as proposed above) and effectively removed from the pool, the first dollar principal loss for the tranche occurs at 17.5% annual default rates. The attachment point would reduce to 8.6%, the detachment point would reduce to 15.0%, and the KSA would be 8.2%. The capital requirement of the remaining structure under the SSFA will be 75.2%, primarily because the SSFA incorporates credit enhancement. The BCRA is clearly not aligned with the risks of the tranche since it penalizes investors by not providing the appropriate recognition for credit enhancement, thereby depriving the BBB investors the benefit from the subordination.

Risk weight floor

Page 31 of the consultative document talks about establishing a risk weight floor of 20% in the revised securitization framework. However, a floor detached from the credit performance history of the underlying assets is inconsistent with the BCBS's objective of improving the risk sensitivity of the securitization framework. This is especially true for short-term securitization exposures, which has very low risk compared to long-term exposures and yet is subject to the same floor. This disconnect in calibration would certainly create perverse incentives (e.g. banks focusing on low-quality exposures to ensure a proper return is earned on the required capital).

The stated goals of the risk weight floor are to reduce cliff effects and mitigate model risks. However, this does not seem to take into account advances made in internal measures and credit rating agency models for securitization, nor improvements in the securitization market in general since the crisis. As explained above, these improvements will mitigate significant ratings downgrade in a stressed period, which is the underlying cause of the cliff effects. Therefore, setting a floor on capital requirements without taking into account the improvements that aim to address the same thing (i.e. cliff effects) will only result in unduly conservative capital requirements particularly for highly-rated securitization exposures.

Maximum capital charge

We would like to get clarity on the use of the term "*SA/IRB securitization framework*" in this sub-section (pages 32-33). For example, when using the term "*IRB framework*" does this refer only to the MSFA and CR_{KIRB} approaches? Likewise, when using the term "*SA framework*" does it apply only to the RRBA and SSFA approaches? In addition, for banks under the SSFA that may either have an approved IRB model for the type of underlying exposures in the securitization or are using SA for the underlying exposures, it should be clarified that the senior tranche would still be capped to the average SA risk weight applicable to the underlying exposures.

Early amortization provision revisions

We would like to note our concern regarding the revision of the early amortization provision. Although clarity is required as to the exact proposal, we are concerned that any limitation in the recognition of risk transfer for structures that include an early amortization trigger would limit banks' ability to continue securitizing their revolving credit portfolios, as most of them have successfully done in the past. This would undoubtedly have a significant impact on credit availability as funding such receivables would become more expensive.

Calibration of the proposals

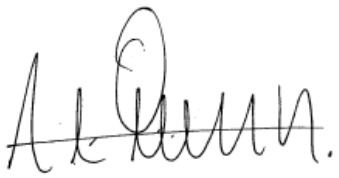
The consultative document noted that the BCBS will consider to what extent and to which specific instances the 1.06 scaling factor used in the Basel II internal ratings-based (IRB) approach would be used in the revised securitization framework (page 37). When Basel II was introduced, there were concerns from regulators that it could significantly reduce capital requirements of banks

because it allowed the use of more risk-sensitive internal measures. Thus, to broadly maintain the aggregate level of capital requirements, the 1.06 scaling factor was introduced for IRB. The industry questions the continued relevance of the scaling factor under Basel III, which has not only increased the minimum capital banks have to hold but also added a number of buffers that make the capital framework significantly more conservative. In the context of the proposed securitization revisions, the consultative document explicitly mentioned the expectation that overall capital requirements for securitization would increase as a result of the proposals (page 37). In fact, as demonstrated in the examples above, the proposed revisions would result in very conservative capital requirements. Hence, we deem that the use of the scaling factor is unnecessary for purposes of the revised securitization framework especially if the BCBS would implement it as proposed.

In summary, the revisions to the securitization framework should reflect in a reasonable way the actual risk of the transactions. In addition, while it is important to address the shortcomings of the current Basel securitization framework, this should be done within the context of the structural progress market participants in securitization have made since the crisis, as well as other bodies of regulations that have made the financial system safer.

Once again, we appreciate the opportunity to comment on the consultative document on *Revisions to the Basel Securitization Framework*. Should you have any questions on the issues raised in this letter, please contact the undersigned (aportilla@iif.com) or Jermy Prenio (jprenio@iif.com).

Sincerely,



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