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Basel Committee for Banking Supervision
c/o Bank for International Settlements
CH-4002
Basel, Switzerland

Submitted via email: baselcommittee@bis.org

SFIG Response to the Consultative Document on Revisions to the Basel III Leverage Ratio Framework

Introduction

The Structured Finance Industry Group (SFIG)[1] appreciates the opportunity to comment on the proposals set out in the consultative document "Revisions to the Basel III Leverage Ratio Framework" published by the Basel Committee on Banking Supervision (the "Committee" or "BCBS") on 25 April 2016 (the "Proposal").[2] We would like to comment on the Proposal with regard to the treatment of traditional and synthetic securitizations.

The Proposal would incorporate the Basel III (that is, the December 11, 2014 "Basel III Document, Revisions to the Securitization Framework", as amended) revisions to the Securitization Framework into the Leverage Ratio where relevant. First, the Proposal seeks to clarify the treatment of traditional securitizations for the purposes of the Basel III Leverage Ratio when a bank meets operational requirements for the recognition of risk transfer in the risk-based framework, but does not meet the criteria for accounting derecognition of securitized assets or must include the related special purpose entity (SPE) within the bank's consolidated group for accounting purposes. We believe that a bank that securitizes assets in a traditional securitization that meets the operational requirements of risk transfer and certain other conditions should be able to exclude the securitized assets from its regulatory balance sheet for Leverage Ratio purposes

[1] SFIG is a member-based, trade industry advocacy group focused on improving and strengthening the broader structured finance and securitization market. SFIG provides an inclusive network for securitization professionals to collaborate and, as industry leaders, drive necessary changes, be advocates for the securitization community, share best practices and innovative ideas, and educate industry members through conferences and other programs. Members of SFIG represent all sectors of the securitization market including issuers, investors, financial intermediaries, law firms, accounting firms, technology firms, rating agencies, servicers, and trustees. Further information can be found at www.sfindustry.org.

[2] BCBS, Consultative Document: Revisions to the Basel III Leverage Ratio Framework (April 2016) (**"BCBS 365"**), available at http://www.bis.org/bcbs/publ/d365.pdf.

even if it does not satisfy all the accounting derecognition or deconsolidation requirements as we set out below in more detail.[3]

Second, the Proposal attempts to deal with the Credit Conversion Factors (CCFs) for off-balance sheet items. We are proposing a change to the CCFs for off-balance sheet securitizations. Namely, a CCF of 50% (instead of the 100% CCF used in Basel III for securitization positions) should apply.[4] Such off-balance sheet securitization exposures most often are commitments given by banks in connection with ABCP Conduits.

Finally, we believe that if a fully funded or collateralized synthetic securitization satisfies all of the Basel III's operational requirements for synthetic credit risk mitigation, the transaction should also be taken account of to reduce the denominator when calculating the Leverage Ratio.

Background

Basel III Leverage Ratio

The Committee defines the Basel III Leverage Ratio as the capital measure divided by the exposure measure, with the ratio expressed as a percentage.[5] Both the capital measure and the exposure measure are calculated on a quarter-end basis. The Leverage Ratio's objective is to make certain that a bank holds an appropriate minimum level of capital at all times in the event that the risk-based measure fails to capture certain risks appropriately. The Committee intends to (i) restrict the build-up of leverage in the banking sector to avoid any destabilizing deleveraging processes that can damage the financial system and the economy; and (ii) reinforce the risk-based requirements with a simple, non-risk-based "backstop" measure.[6]

Basel III Risk-Based Capital Rule and Operational Requirements

Under the Basel III risk-based capital rule, "banks must apply the securitization framework for determining regulatory capital requirements on exposures arising from traditional and synthetic securitizations or similar structures that contain features common to both."[7] The Basel III revised securitization framework aimed to make capital requirements for all securitizations more risk-sensitive.

The Committee has established operational requirements for both traditional securitizations and for synthetic securitizations that use credit risk mitigation techniques that, in both cases, are designed to ensure that they achieve risk transfer necessary to be recognized for regulatory capital

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[3] BCBS, Basel III Document: Revisions to the Securitisation Framework (December 2014) (**"BCBS 303"**), available at http://www.bis.org/bcbs/publ/d303.pdf; BCBS, Consultative Document: Revisions to the Standarised Approach for Credit Risk (December 2015) ("**BCBS 347")**, available at http://www.bis.org/bcbs/publ/d347.pdf.

[4] BCBS 365, page 27.

[5] BCBS 365, page 5.

[6] BCBS 365, page 1.

[7] BCBS 303, para. [1].

purposes.[8] For operational requirements for traditional securitizations, an originating bank may exclude underlying exposures from the calculation of risk-weighted assets *only if* they meet all the following conditions:

- Significant credit risk associated with the underlying exposures has been transferred to third parties (SRT).

- The transferor does not maintain effective or indirect control over the transferred exposures.

- The securities issued are not obligations of the transferor.

- The transferee is an SPE and the holders of the beneficial interests in that entity have the right to pledge or exchange them without restriction.

- Clean-up calls must satisfy the conditions set out in paragraph [28] of the revisions to the securitization framework.

- The securitization does not contain clauses that (i) require the originating bank to alter the underlying exposures such that the pool's credit quality is improved unless this is achieved by selling exposures to independent and unaffiliated third parties at market prices; (ii) allow for increases in a retained first-loss position or credit enhancement provided by the originating bank after the transaction's inception; or (iii) increase the yield payable to parties other than the originating bank, such as investors and third-party providers of credit enhancements, in response to a deterioration in the credit quality of the underlying pool.

- There must be no termination options/triggers except eligible clean-up calls, termination for specific changes in tax and regulation or early amortization provisions which according to paragraph [26] result in the securitization transaction failing the operational requirements set out.

For synthetic securitizations, the use of credit mitigation techniques – collateral, guarantees, and credit derivatives – for hedging the underlying exposure may be recognized for risk-based capital purposes *only if* all of the conditions outlined below are satisfied:

- Credit risk mitigants must comply with the requirements set out in Section II.D of the Basel II framework.

- Eligible collateral is limited to that specified in paragraphs [145] and [146] of the Basel II framework. Eligible collateral pledged by SPEs may be recognized.

- Banks may not recognize SPEs as eligible guarantors in the securitization framework.

[8] BCBS 303, pages 11-12.

- Banks must transfer significant credit risk associated with the underlying exposures to third parties (SRT).

- The instruments used to transfer credit risk may not contain terms or conditions that limit the amount of credit risk transferred.

- A bank should obtain legal opinion that confirms the enforceability of the contract.

- Clean-up calls must satisfy the conditions set out in paragraph [28].

Basel III CCFs for Securitizations

The Annex to the Proposal in paragraph 15 provides that "OBS securitization exposures must be treated as per the second bullet of paragraph 20 of the Basel III securitization framework."[9] That second bullet provides for 100% CCFs with some exceptions (including for servicer advances) for securitizations. By contrast, the existing Basel Leverage rules permit a 50% CCF for off-balance sheet securitization exposures that are eligible liquidity agreements for ABCP Conduits.[10]

Analysis

Treatment of Traditional Securitizations: How Should Traditional Securitizations be Treated for Calculation of the Denominator?

The Proposal indicates that the Committee is working on clarification regarding the treatment of traditional securitizations when an originating bank meets operational requirements for the recognition of risk transfer in the risk-based framework, but does not meet the criteria for accounting derecognition of securitized assets or has to include the SPE within its scope of accounting consolidation.[11]

Under those circumstances, the originating bank clearly may exclude the securitized assets from the calculation of its risk-weighted assets (RWAs). In Section III.4 of the Proposal, the Committee suggests that it is possible to interpret such exclusion from the calculation of RWAs to mean either: (i) the securitized assets are excluded from the regulatory scope of consolidation and therefore should also be excluded from the Basel III Leverage Ratio exposure measure; or (ii) the securitized assets are included within the regulatory scope of consolidation, and therefore should be included in the Basel III Leverage Ratio exposure measure, but receive a 0% risk weight under the risk-based framework.[12]

[9] BCBS 365, page 27.

[10] BCBS 365, page 26.

[11] Of course, transactions that achieve off-balance sheet derecognition and deconsolidation requirements should not be included in the Leverage Ratio denominator.

[12] BCBS 365, page 10.

We believe that a bank that meets the operational requirements of risk transfer in a traditional securitization and has isolated the transferred assets from the solvency risk of the originator and its affiliates[13] should be able to exclude the securitized assets from its regulatory balance sheet for Leverage Ratio purposes, even if the bank does not satisfy all accounting derecognition or deconsolidation requirements. In these circumstances, the assets that should be counted in the denominator of the Leverage Ratio for securitizations are not those of a generally accepted accounting principles balance sheet – as those principles are generally based on issues concerning disclosure or control, and *not* completely on legal, economic or other exposure to the risk of the assets transferred – but rather those assets the transfer of which does not meet either (i) the Basel III operational requirements for removal of assets from risk-weighting or (ii) the Isolation Condition, as those principles *are* based fully on removal from the originator of legal, economic or other exposure to the risk of the assets transferred.

To construct a soundly structured Leverage Ratio, it is important that the calculation takes account of the actual transfer of exposure to risk in the securitization. Most securitizations remain consolidated on banks' balance sheets because of restrictive accounting rules that make deconsolidation of securitization SPEs difficult if banks or consolidated affiliates retain servicing and a potentially significant portion of the most subordinated tranches. Because accounting derecognition and consolidation rules do not turn on the exposure, legal or otherwise, to the risk of the tranches that are transferred to third parties, it is not appropriate to require compliance with such accounting rules in order for the securitization to be recognized for Leverage Ratio purposes. Rather, if a securitization and transfer to unaffiliated third parties achieves a SRT, otherwise complies with the related operational requirements for the commensurate reduction in risk-weighted assets, and complies with the Isolation Condition, it is also appropriate to remove the securitized assets from, and include only the retained tranches in the denominator of the Leverage Ratio.

Our Leverage Ratio proposal for a pool of securitized assets, the transfer of which meets each of the requirements outlined in the preceding paragraph, would be to add to the denominator not the full amount of the assets in the pool but rather the product of (i) the nominal amount of the total assets in the pool multiplied by (ii) a fraction with a numerator equal to the nominal amount of the tranches retained and a denominator equal to the nominal amount of all of the assets in the pool as follows:

$$nominal\ amount\ of\ total\ assets\ in\ the\ pool * \frac{nominal\ amount\ of\ tranches\ retained}{nominal\ amount\ of\ total\ assets\ in\ the\ pool}$$

For example, in a securitization where a bank sells all of the senior tranches to third party investors and retains a portion of the subordinated tranches, the portion of assets added to the denominator for purposes of calculating the Leverage Ratio would be equal to total assets in the pool multiplied by the above fraction. If the pool were $100, and the retained tranches were $10, the addition to the denominator would equal $\$100 * 10/100 = 10$. As a safeguard, the bank should meet all the

[13] For example, in the U.S. this would involve obtaining a "true sale" under applicable state law and structuring to avoid "substantive consolidation" of the of applicable SPE with the originator. Such isolation will vary from jurisdiction to jurisdiction and here we call achieving such isolation the "Isolation Condition".

operations requirements, including SRT to an independent third party, and the Isolation Condition, and only then would our proposal apply the ratable reduction.

Revisions to the Credit Conversion Factors for Off-Balance Sheet Items: What CCFs or Other Adjustments are Appropriate for Calculating the Denominator for Securitizations?

Credit Conversion Factors

In Section III.1 of the Proposal, the Committee proposes to incorporate into the Basel III Leverage Ratio framework the revised CCFs for off-balance sheet items that are contained in the Committee's December 2015 proposed revisions to the standardized approach for credit risk, once those revised CCFs are finalized and implemented in the revised standardized approach.[14] Until the standardized approach revisions are finalized and implemented, the Committee plans to retain the current CCFs in the Basel III Leverage Ratio framework. For off-balance sheet securitization exposures, the Committee proposes to apply for Leverage Ratio framework purposes the same treatment as under the revised Basel III securitization framework.[15]

As we stated earlier, we believe that CCFs for off-balance sheet securitization positions, which basically consist of eligible liquidity facilities for ABCP programs, should follow not the new proposed 100% CCF, but instead the existing CCF of 50%. We support this figure based on research demonstrating that 50% is an adequately conservative number for use in the Leverage Ratio to protect banks in times of stress.

An industry study conducted by AFME shows that ABCP Conduits drew on unused commitments even during such times of financial stress on average substantially below 50% of the unused commitments and on average even below 15% of the unused commitment amounts.[16] These results provide empirical support for our proposal that a 50% CCF is sufficiently conservative for Leverage Ratio purposes.

Synthetic Credit Risk Mitigation

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[14] BCCS 347, para. [64]-[74].

[15] BCBS 365, page 9; BCBS 303, pages 9-10.

[16] *Please see* GFMA, IIF, ISDA, JFMC & the Clearing House, Comments in Response to the Consultative Document on Revisions to the Basel III Leverage Ratio Framework (July 2016), pages 33-34 and *Annex 1*, available at http://gfma.org/correspondence/item.aspx?id=825, for a discussion of the details of the study. These details include the facts that the study covered more than a majority of the market, the time period involved included the financial crisis, even at its peak liquidity funding did not exceed 5.45% of total program funding requirements, on average liquidity funding accounted for only 1.6% of average funding requirements, liquidity funding varied little over the time frame involved and for the unutilized portion (with which the CCF of course deals): the monthly variation in terms of the commitments never exceeded 4.34%; expressed as a percentage of the unutilized portion, the monthly variation never exceeded 13.72%; applying the same methodology at the individual sponsor level, the average monthly variation in the utilized portion was 8.13%; and the 95th percentile in monthly variation was no more than 16.62%. Finally, there were no "runs" on either the utilized or unutilized portion as all ABCP liquidity funding is constrained by actual assets available to secure the ABCP. An originator can only utilize the facility if its business generates receivables to fund; when business declines, so does the available amount of the commitment.

We also believe that if CCFs are used to determine the treatment of off-balance sheet securitization exposures for Leverage Ratio purposes, synthetic securitization credit risk mitigation should also be recognized for Leverage Ratio purposes. More specifically, the Committee should permit synthetic credit risk mitigation that both satisfies the relevant operational requirements and is fully funded or collateralized to reduce the denominator of the Leverage Ratio. Fully funded synthetic credit risk mitigation not only reduces contingent funding risk, but essentially constitutes a cash transaction.

The securitization concepts provide thorough and logical ways to reduce risk sufficiently to justify removal of the position from the denominator for purposes of calculating the Leverage Ratio. We set out above the operational requirements of securitization to demonstrate how thoroughly securitization ensures the transfer of risk. In fact, the Committee has stated that:

> The process of securitization from the originator's perspective can be viewed as similar to credit risk mitigation, as at least some risk of the underlying exposures is transferred to another party. Under this view, it would be inappropriate for a bank to have to hold more capital after securitization than before, as its risk should be reduced through the process of securitization. Supporting this concept is the operational requirement that significant risk be transferred in order to recognize any benefits from a securitization for originators and sponsors.[17]

The Basel III Leverage Ratio should recognize synthetic securitizations for removal from the denominator only when they not only satisfy the operational requirements for credit risk mitigation, but also only in circumstances in which there is no risk that the counterparty will be unable to meet its obligations (i.e., when the credit risk mitigation is fully funded, or where an unfunded guarantee or credit derivative is fully collateralized by collateral that meets the operational requirements for funded credit risk mitigation). We believe that these additional safeguards add sufficient protection to satisfy any concerns that reduction of risk will be illusory in the case of synthetic transactions.

Securitization Can Nurture the Real Economy

Securitization should be encouraged to finance the real economy, especially for small and medium-sized businesses. If banks become constrained by a measure of capital adequacy that does not take adequate account of economic reality, the constraint will artificially affect the way that banks allocate capital to business lines. The result will be uneconomic adjustments to pricing and availability of products that are important to the functioning of the so-called real economy.

Many policymakers now believe that securitization should be encouraged to nurture the economy.[18] According to the press release by the European Commission, securitization "is an

[17] BCBS, Consultative Document: Revisions to the Basel Securitization Framework (December 2012) , page 32, available at http://www.bis.org/publ/bcbs236.pdf. The quoted language is from an early stage Consultative Document, but it accurately explains the concept that underlies credit risk mitigation.

[18] For example, for the European Union, please see European Commission, Proposal for a Regulation of the European Parliament and of the Council Laying Down Common Rules on Securitization and Creating a European Framework for Simple and Transparent Securitization (30 September 2015), available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015SC0185&from=EN.

important channel for diversifying funding resources and enabling a broader distribution of risk by allowing banks to transfer the risk of some exposures to other banks, or long-term investors…. This allows banks to 'free' the part of their capital that was set aside to cover for the risk in the sold exposures, thereby allowing banks to generate new lending." Also, securitization can "lead to more credit for businesses and households" and also "provide additional investment opportunities."[19] The European policymakers in particular have recognized banks' struggles to extend credit due to the series of strict regulations adopted in the aftermath of the financial crisis.

The Interactions between Multiple Restrictions on Liquidity and Securitization may Harm the Real Economy

The Committee should consider the combined effects of multiple regulatory restrictions on securitizations and market liquidity in general. The Committee has adopted two minimum standards for funding and liquidity: the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). With the objective of promoting short-term resilience of a bank's liquidity risk profile, the LCR requires a bank to maintain an adequate stock of unencumbered high quality liquid assets (HQLA) to meet its liquidity needs for a stressed 30-day period.[20] Additionally, the NSFR requires a bank to maintain an amount of available stable funding at least equal to the amount of its required stable funding.[21] However, these requirements have been designed such that no credit is given for the liquidity value of asset-backed securities (ABS) and not much credit is given for mortgage-backed securities (MBS).[22]

Furthermore, other regulatory restrictions affecting securitization also have become more stringent over the years. In particular, the Committee's Fundamental Review of the Trading Book materially increases the risk-weights of securitization exposures in the trading book, sometimes by multiples of capital.[23]

The Committee also has pending several other proposals that would place further limits on securitization. For example, the Committee has proposed that banks be barred from using internal

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[19] European Commission, Press Release, A European Framework for Simple and Transparent Securitization, (30 September 2015), available at http://europa.eu/rapid/press-release_MEMO-15-5733_en.htm.

[20] BCBS, Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools (January 2013), available at http://www.bis.org/publ/bcbs238.pdf.

[21] BCBS, Basel III: The Net Stable Funding Ratio (January 2014), available at http://www.bis.org/bcbs/publ/d295.pdf.

[22] The LCR is expressed as the value of HQLA divided by the total net cash outflows over next 30 calendar days. HQLA are comprised of Level 1 and Level 2 assets. Level 1 assets generally include cash, central bank reserves, and certain marketable securities backed by sovereigns and central banks. Level 2 assets are comprised of Level 2A and Level 2B assets. Level 2A assets include certain government securities, covered bonds and corporate debt securities. Level 2B assets include lower rated corporate bonds, residential mortgage backed securities (RMBS) and equities that meet certain conditions. ABS or other forms of MBS are not included. Level 2B assets may not account for more than 15% of a bank's total stock of HQLA. Similarly, the NSFR gives credit to only RMBS with a credit rating of at least AA.

[23] BCBS, Standards: Minimum Capital Requirements for Market Risk (January 2016), available at http://www.bis.org/bcbs/publ/d352.pdf.

models to calculate risk for wholesale exposures such as banks and large corporates.[24] This may well have a material impact on securitization exposures under the SEC-IRB approach for instance through the application of higher risk-weights to the individual positions that are used to calculate the capital of the underlying securitization pool (KIRB). We also expect a reduction of the scope of the SEC-IRB approach. Currently, a bank must calculate KIRB for at least 95% of the underlying risk-weighted exposure amounts but may not be able to do so if the underlying exposures are no longer eligible for IRB, as will be the case for wholesale and specialized lending exposures.[25] Additionally, the Committee has undertaken a process to identify and address step-in risk – the risk that a bank may provide financial support to an entity beyond or in the absence of any contractual obligations due to reputational risk.[26]

Failure to recognize for Leverage Ratio purposes transfers to third parties through securitizations that satisfy both operational requirements (including SRT) and the Isolation Condition and therefore result in reduction of a bank's exposure to legal, economic and other risk of the assets transferred, would significantly exacerbate the already unfavorable regulatory environment for securitizations and likely further reduce market liquidity for ABS and MBS and the amount of primary issuances. Issuers will not be able to charge economically rational prices for ABS and MBS, and underwriters will be discouraged from creating secondary market liquidity for primary issuances, thus further discouraging primary issuance. Consequently, the real economy will suffer.

Conclusion

We appreciate the work that the Committee has achieved in developing the Proposal. We believe that the Committee can improve the Proposal considerably. *First*, we believe that a bank that securitizes assets in a traditional securitization while complying with the operational requirements of risk transfer in Basel III and the Isolation Condition should be able to exclude the securitized tranches sold to third parties from the denominator of the Leverage Ratio, even if the bank does not meet all accounting derecognition or deconsolidation requirements. This is because the Bank will have eliminated the bank's exposure to legal, economic and other risk of the transferred tranches. *Second*, the Committee should continue to permit use of a 50% CCF for off-balance sheet securitizations consisting of ABCP conduit funding facilities. The actual funding history of ABCP conduits during the recent financial crisis justifies that treatment. *Third*, the Proposal should remove fully funded or collateralized synthetic credit risk mitigation transactions that meet all of the related Basel III operational requirements in the calculation of the denominator of the Leverage Ratio calculated. Incorporating these changes into the Leverage Ratio Proposal is necessary to promote a safe and robust market for securitization and to support the real economy.

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[24]BCBS, Consultative Document: Reducing Variation in Credit Risk-weighted Assets – Constraints on the Use of Internal model Approaches (March 2016), available at http://www.bis.org/bcbs/publ/d362.pdf.

[25] *Please see* GFMA, ISDA, IACPM & JFMC, Joint Association's Comments on the BCBS Consultative Document: Reducing Variation in Credit Risk-Weighted Assets – Constraints on the Use of Internal Model Approaches (June 2016), available at http://gfma.org/correspondence/item.aspx?id=820.

[26]BCBS, Consultative Document: Identification and Measurement of Step-in Risk (December 2015), available at http://www.bis.org/bcbs/publ/d349.pdf.

SFIG appreciates the opportunity to provide the foregoing comments. Should you wish to discuss any matters addressed in this letter further, please contact me at (202) 524-6301 or at richard.johns@sfindustry.com.

Respectfully submitted,

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