May 31, 2001

Basel Committee on Banking Supervision
The Bank for International Settlements
CH-4022 Basel
Switzerland


Ladies and Gentlemen:

The Bond Market Association (the “Association”)\(^1\) appreciates the opportunity to comment on those aspects of the Consultative Document entitled “The New Basel Capital Accord” dated January 2001 (“Basel II Accord”) that affect the commercial paper market in the United States.\(^2\) Specifically, this letter will focus on the issues raised by the Basel II Accord for liquidity lines of credit that back-stop corporate commercial paper programs.

I. Executive Summary

The Association believes that the proposed increase in the credit conversion factor for commitments of less than one year from 0% to 20% substantially overstates the risk of a draw on such commitments to highly rated issuers of commercial paper. Therefore, we recommend that the credit conversion factor for such commitments to highly rated issuers of commercial paper should be either maintained at 0% or, if increased from 0%, should be set at a level not greater than 10%.\(^3\) In addition, we believe that the proposed credit conversion factor for such commitments should be adjusted downward independently of the credit risk weighting for corporate claims.

\(^1\) The Association represents securities firms and banks that underwrite, distribute and trade debt securities domestically and internationally. The Association’s member firms account for in excess of 95% of all primary issuance and secondary market trading activity in the U.S. debt capital markets. The views in this letter reflect input from the Association’s Money Market Committee, which includes representatives of many securities firms that are active in placing commercial paper. More information about the Association and its members and activities may be found at its Website at [www.bondmarkets.com](http://www.bondmarkets.com).

\(^2\) We note that the Association and its affiliated organization, the European Securitisation Forum (ESF), are also submitting comment letters to you under separate cover concerning the impact of the Basel II Accord on asset securitization and the market for repurchase and securities lending transactions.

\(^3\) Obligors with a short-term rating of A-1/P-1/F-1 are referred to in this letter as “highly rated obligors.” The three major rating agencies in the United States are Standard & Poor’s, Moody’s Investor Service and Fitch IBCA Duff & Phelps. The highest short-term rating assigned by these agencies is A-1, P-1 and F-1, respectively. Standard & Poor’s and Fitch add a “+” modifier to their A-1 and F-1 ratings for certain obligors that are at the upper end of these rating categories. 89% of the Moody’s rated commercial paper in the global commercial paper market is rated P-1. Moody’s Investor Service, “Moody’s Approach to Assessing the Adequacy of ‘Liquidity Risk Insurance’,” January 2000, page 10 (cited as “Moody’s CP Default Study”).
II. Commercial Paper Market in the United States

The commercial paper market in the United States is a critical component of the capital markets. At the end of 2000, $1.6 trillion in commercial paper was outstanding in the United States. Commercial paper represented the largest segment of the overall U.S. money market of $2.665 trillion at the end of 2000. In addition, commercial paper represents a significant portion of the overall debt market of $16.0 trillion in principal amount outstanding at the end of 2000. Moreover, the rate of commercial paper issuance has accelerated in recent years, as commercial paper has increasingly become a permanent feature of issuers’ balance sheets and as overall economic activity has increased in the United States. Commercial paper has proven to be a valuable and flexible tool in financing the needs of U.S. and international businesses.

The Association’s member firms have a significant interest in the continuing vitality of the commercial paper market in the United States and internationally. A number of these firms act as intermediaries for issuers by placing commercial paper with investors. In addition, when necessary, such firms may act as a provider of liquidity to investors who decide to sell commercial paper prior to its stated maturity date. Therefore, these firms have a stake from both a reputational and credit viewpoint in a commercial paper market that is premised on reasonable and sound structural requirements, including capital allocation methodologies.

Credit ratings by rating agencies play a critical role in the commercial paper market due to both technical and business factors that create strong incentives for the purchase by investors of commercial paper that is rated by one or more nationally recognized statistical rating organizations. The various rating agencies in the United States that provide credit ratings for corporate commercial paper have established criteria for such ratings. These criteria include the requirement that an issuer must have unfunded commitments from lenders equal to a certain percentage, depending on the rating of the issuer, of the commercial paper that the issuer may have outstanding from time to time. These unfunded commitments are generally characterized in the market as “commercial paper back-up facilities,” even though there is no requirement that these facilities must be expressly linked to the issuer’s commercial paper program. In addition, due to the short

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8 Rule 2a-7 under the Investment Company Act of 1940 limits the amount of commercial paper not in the highest short-term rating category (i.e., A-1/P-1/F-1) that may be held by a money market fund.
9 An express linkage to a commercial paper program could, in theory, be established through documentary provisions that, for example, restrict draws on the back-up facility to those whose proceeds are used to redeem commercial paper. Our understanding, however, is that such provisions are not a common documentary practice in the United States. Although the Association is not taking a position on the desirability of such provisions, some of its member firms have noted that an additional element of comfort
maturity of much commercial paper, many of these commitments have taken the form of committed facilities with a maturity date of less than one year.

The methodologies behind the requirement for back-up facilities vary among the rating agencies but the required percentage is substantial even for the highest rated credits and in many cases is 100%. Therefore, the availability of these facilities is a critical element in the ongoing viability of the commercial paper market. However, this market has, in the last several years, experienced “a marked change . . . in the cost and availability of traditional bank commercial paper back-up facilities.” Issuers have observed that committed bank facilities to back-up commercial paper have become less readily available. This issue has become particularly acute against the backdrop of increased levels of commercial paper issuance.

Although a number of factors may account for the decreased availability of commercial paper back-up facilities, it appears that the proposed changes in the Basel II Accord affecting commitments of less than one year are significantly contributing to the phenomenon of decreased availability of back-up facilities. Moody’s has commented that “the anticipated increase in capital charges for already-scarce liquidity back-up lines will, if adopted, squeeze both the availability of liquidity and its cost as a bank product.” Therefore, it is to such changes that the comments in this letter are addressed.

III. Treatment of Commitments under the Basel II Accord

Paragraph 43 of the Basel II Accord states that the credit conversion factor for commitments with an original maturity up to one year will be 20%. This credit conversion factor represents an increase from the current credit conversion factor of 0%.

would be created for investors in commercial paper that is backed up by liquidity lines containing such provisions.


12 Ibid.

13 The issue has become so acute that Moody’s, for example, has begun to assess the availability of sources other than commercial paper back-up facilities in analyzing the adequacy of a particular issuer’s liquidity. See, e.g., Moody’s Liquidity Paper.

14 Moody’s Investors Service, “Proposed Revisions to the 1988 Basel Accord May Raise Costs and Squeeze Availability of ABCP Liquidity,” April 20, 2001, page 1. This observation, which is made with regard to back-up facilities for asset-backed commercial paper, applies equally to back-up facilities for corporate commercial paper. It is worth noting that this squeeze on liquidity facilities backing up commercial paper programs has occurred at a time when liquidity in short-term U.S. Treasury securities has been negatively affected by declining supply.

15 This letter does not address the credit conversion factor for commitments with an original maturity of more than one year, nor does it address credit conversion factors for asset-backed commercial paper (ABCP) liquidity facilities, which are separately addressed in the Association’s and the ESF’s securitization comment letters noted above.
As noted above, many commercial paper back-up facilities have an original maturity date of one year or less, which means that they currently carry a credit conversion factor of 0%. Paragraph 43 of the Basel II Accord does not set forth a rationale for the increase in the credit conversion factor from 0% to 20% for such facilities. However, we believe that the credit conversion factor should capture the likelihood that an off balance sheet item would be brought onto the balance sheet as a result of a draw on an unfunded commitment. In this regard, we believe that a credit conversion factor of 20% is too high. Therefore, we recommend that (a) the existing credit conversion factor of 0% should be retained for commitments of less than one year to such issuers, or (b) if such credit conversion factor is increased, the factor should be set at a level of not greater than 10%.

A. A credit conversion factor of 20% for corporate commercial paper back-up facilities of less than one year substantially overstates the likelihood of a draw for the segment of the market represented by facilities extended to obligors possessing a rating of A-1/P-1/F-1.

Data concerning the utilization of commercial paper back-up facilities of less than one year to highly rated obligors is not readily available. This is due to factors such as the confidentiality surrounding relationships between lenders and their customers and the fact, as noted above, that these facilities are generally not expressly earmarked or tied to commercial paper programs. However, the Association believes that the risk of draws on such facilities is low for the following reasons:

- Highly rated obligors are able to benefit from less expensive cost of funding in the commercial paper market than would be represented by drawn pricing on bank facilities of equivalent maturity. The growth of commercial paper issuance is based to a great extent on this economic fact.
- During periods of concern about credit issues in the commercial paper market, which is often expressed in the form of spread widening for obligors that are not highly rated, investment flows in the money market are directed to highly rated obligors. This phenomenon, which is commonly referred to as the “flight to quality,” means that there is little incentive for highly rated obligors to draw on commercial paper back-up facilities, because they continue to benefit from investment flows, particularly in times of stress.
- In light of the economics of the commercial paper market as described above, a highly rated obligor might draw on a commercial paper back-up facility if it were otherwise on the verge of defaulting on outstanding commercial paper. The dealers represented on the Association’s Money Market Committee are not aware of any situation where a highly rated obligor (i.e., an obligor rated A-1/P-1/F-1) has threatened to default or has actually defaulted on commercial paper.16

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16 Moody’s data shows that of the 11 rated commercial paper issuers that have defaulted in the period from 1972 to 2000, 10 issuers were rated NP (Not Prime) at the time of default and 1 issuer was rated P-2. Moody’s CP Default Study, page 15.
• A highly rated obligor might also draw on a commercial paper back-up facility in a case where such obligor was on the verge of migrating downward in its short-term credit rating. A rating of less than A-1/P-1/F-1 entails materially higher costs of funding through commercial paper\textsuperscript{17} and could create an incentive for anticipatory draws against a back-up facility. Therefore the risk that an issuer may be downgraded from the highest short-term rating category is a reasonable proxy for the risk that a draw could occur on the liquidity facility backing up such issuer’s commercial paper. A review of the migration history of commercial paper issuers that are highly rated obligors reveals that downgrades of highly rated obligors represent a modest percentage, on a weighted average basis, of the overall commercial paper market. Moody’s average rating transition matrices show a less than 10\% transition rate, over a 365-day period, of issuers with a P-1 rating into a lower rating category.\textsuperscript{18}

For these reasons, the Association believes that the credit conversion factor for unfunded commitments of less than one year to corporate issuers rated A-1/P-1/F-1 should be retained at 0\% or, if increased, set at a level not greater than 10\%.

\textbf{B. The credit conversion factor for unfunded commitments of less than one year to highly rated obligors should be adjusted downward independently of the risk weighting for corporate claims.}

The Association believes that the “standardized approach” to risk weighting for corporate claims that is set forth in paragraph 35 of the Basel II Accord is a step forward in recognizing the different levels of credit risk, and therefore capital allocation, applicable to claims on corporate obligors. However, we also believe that any adjustment of the credit conversion factor for unfunded commitments of less than one year should be considered independently of the relevant credit risk-weighting factor. The reason is that the credit conversion factor should capture the risk that an off-balance sheet item (an unfunded commitment) would be transformed into an on-balance item sheet via a draw. The risk-weighting factor should capture the risk that an obligation would not be repaid by a corporate obligor in accordance with its terms.

In this regard, we believe that, as explained above, there are a number of factors that help to create a low level of risk of draw on an unfunded commitment of less than one year to a highly rated obligor. These factors are of an economic and practical nature. As a result, the Association believes that the calculation of the capital required for an unfunded commitment of less than one year should be as follows:

\textsuperscript{17} Over the period from early December 2000 to late May 2001, the spread between commercial paper in the highest rating category (i.e., A-1/P-1/F-1) and commercial paper in the second highest rating category (i.e., A-2/P-2/F-2) ranged from a low of 22 basis points to a high of 122 basis points.

\textsuperscript{18} Moody’s CP Default Study, page 21, which shows, in the 365-day transition matrix, that 90.24\% of issuers rated P-1 remain in the P-1 rating category. It is worth noting that in this matrix, only 3.2\% of the P-1 obligors transition to a rating of P-2, P-3 or NP. 6.56\% of the P-1 credits transition to a rating of “Withdrawn Rating,” which encompasses a variety of situations. Not all of these situations necessarily involve increased credit risk.
Dollar amount of the commitment multiplied by (1) the applicable credit conversion factor, multiplied by (2) the applicable risk-weighting factor, multiplied by (3) 8%.

We believe that this methodology is currently being used to calculate capital that is applicable to unfunded commitments of more than one year. However, an express statement that such a methodology is consistent with the Basle II Accord would provide much needed clarity.

If the credit conversion factor for unfunded commitments of less than one year to a highly rated obligor were to be adjusted downward to 10% rather than 20%, the capital applicable to such a commitment extended to a hypothetical obligor with a short term rating of A-1/P-1/F-1 and a long term rating of AA- would be as follows:

Dollar amount of the commitment, multiplied by 10% (credit conversion factor), multiplied by 20% (risk-weighting factor), multiplied by 8%.

Even if the credit conversion factor for unfunded commitments of less than one year to a highly rated obligor were not to be adjusted downward from 20%, we believe that the capital applicable to such a commitment to an obligor with the ratings mentioned above should be calculated as follows:

Dollar amount of the commitment, multiplied by 20% (credit conversion factor), multiplied by 20% (risk-weighting factor), multiplied by 8%.

We believe that this method of calculating capital reflects the true risk associated with unfunded commitments of less than one year to highly rated obligors.

IV. Conclusion

We appreciate the opportunity to comment on the impact of the Basel II Accord on liquidity facilities backing up corporate commercial paper. Commercial paper is a critical financing tool for corporations and an important investment vehicle for money market funds in the United States. Liquidity facilities that back up commercial paper are an essential feature of the commercial paper market, at least for commercial paper that is rated. In light of the low level of risk of draw associated with commitments of less than one year to obligors possessing a rating of A-1/P-1/F-1, the Association believes that the credit conversion factor for such commitments to such obligors should be maintained at 0% or, if increased, set at a level not greater than 10%.
If you require any further information on the matters addressed in this letter, please contact the undersigned at 212.440.9476.

Very truly yours,

/s/ Michel de Konkoly Thege

Michel de Konkoly Thege
Vice President and Associate General Counsel

cc: Money Market Committee of The Bond Market Association