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The Secretariat of the Basel Committee on
Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

BY LETTER AND BY E-MAIL

30 July 2003

Our Ref AJXF

Dear Sir/Madam

Re: Basel Accord – CP3 – Securitisation Proposals

The Basel Committee has asked the financial services industry for comments on the proposals contained in consultation paper 3 (the "**proposals**") to reform the 1988 Basel Accord (the "**Accord**").

We are an international legal practice with wide experience of advising the world's leading companies, financial institutions and governments. To that end, we have had substantial experience of transactions which will be fundamentally affected by the reforms.

We set out below various comments in relation to the proposals for the securitisation market (comments set out in the order in which the paragraphs appear in the proposals).

Overview

In the overview (at paragraph 34) the Committee has stated that "*securitisation is important in helping to provide better risk diversification and to enhance financial stability*." However, we do not think that this statement is borne out in the main body of the proposals which we regard as too draconian in their approach.

We make the following particular observations. References to paragraph numbers are to paragraph numbers in the proposals unless otherwise stated.

The definition of securitisation

Securitisation is defined widely (paragraph 502) to include structures where "*cash flow from an underlying pool of exposures is used to service at least two different stratified risk positions or tranches reflecting different degrees of credit risk….the stratified/tranched structures that characterise securitisations differ from ordinary senior/subordinated debt instruments in that junior securitisation tranches can absorb losses without interrupting contractual payments to more senior tranches,* ***whereas subordination in a senior/subordinated debt structure is a matter of priority of rights to the proceeds of a liquidation***. [our emphasis]"

We would make two comments on this.

First, it is so widely drawn that it could include any structure where there is more than one class of bonds. This will create uncertainty. In particular, there is no mention of the need for a transfer of assets – which is certainly the case in a traditional securitisation. To the extent that more complex structures have evolved (for example, whole business securitisations or project bonds in the UK) such structures should be dealt with in the context of specialised lending rather than in the context of securitisation.

Secondly, the latter part of the description is inaccurate. We have highlighted the relevant wording above. Subordination in a senior/subordinated debt structure which is financed through the banking markets (a "**mezzanine banking structure**") rather than the capital markets is not merely a question of priority of rights to the proceeds of a liquidation. In a mezzanine banking structure detailed inter-creditor agreements are put in place the provisions of which create different priorities in different environments, both pre and post insolvency (for an example of some recent case law see *Redwood Master Fund Ltd and Others v TD Bank Europe Ltd and Others* [2002] All ER (D) 141 (Dec)). Loans are choses in action under English law - as are bonds. It is possible to ensure that payments to senior loan holders continue uninterrupted in a mezzanine banking structure in the same way that it is in a securitisation structure. The difference in this latter circumstance is that those lending as junior creditors in a mezzanine banking structure will be subject to less penal risk weightings under these proposals than those lending as junior investors in a securitisation structure. We do not understand the rationale for such a distinction.

The definition of "originator"

In paragraph 507(b) the definition of "originating bank" is wide enough to include a bank which provides liquidity to a conduit structure. This does not seem appropriate to us. When considered in the light of the new rules on liquidity facilities (see further below), it seems an unusually harsh approach. It is also difficult to apply. In particular, the operational rules set out at paragraph 516 rest on the assumption that there is a transferor – that would not be the case in these circumstances.

Similar points apply where the bank is doing no more than provide credit enhancement in a conduit structure. Once again paragraph 507(b) suggests that the bank should be deemed an "originator" solely for this reason. Provisions relating to retained exposures and the isolation of the transferor make no sense in this context.

As an example of the possible confusion, take the following example:

- a bank on the standardised approach provides credit enhancement to an ABCP conduit programme;
- there is no other credit enhancement;
- the programme is set up and sponsored by a third party which consolidates the relevant conduit onto its own balance sheet.

Compare paragraphs 507, 534 and 543 in this regard. Paragraph 534 creates specific rules where the bank concerned has an exposure which is second loss or better in an ABCP programme. These rules would not be relevant given the lack of a first loss position in these circumstances. Paragraph 543 states that "*where a bank other than the originator provides credit protection to a securitisation exposure it must calculate a capital requirement on the covered exposure as if it were an investor*." Is one to assume that the bank providing credit enhancement in this example is an originator solely because of the effect of 507(b) (so that in effect there are two originators?)? If the rating of the exposure could never be less than BB+ due to an asset quality test at the portfolio level, should the bank be deducting the position direct from capital (which it would have to as an originator) or weighting it at 350% (which it would have to as an investor)? Additionally, is the sponsor in this example an originator or not? Paragraph 506 defines an investing bank as an "*institution, other than the originator, sponsor or servicer*" as if these last three were distinct categories – even though it is clear from paragraph 507(b) that where a bank **is** a sponsor it is deemed to be an originator. The result is incoherent and confusing.

To the extent that credit enhancements and liquidity need to be dealt with it surely makes more sense to have separate treatments rather than creating possible anomalies by widening the definition of originator. If such treatments need to be varied to reflect the nature of ABCP structures then it will be clearer to create specific treatments according to the nature of the facility rather than attempting to import such variations via the definition of originator. In particular, the present approach could mean that there is more than one originator in a given structure – that will make it very difficult to apply the rules in a clear and consistent manner.

The definition of "credit enhancement"

This seems an opaque definition (paragraph 509) given its significance for the calculation of the supervisory formula. In particular, it seems that the rules relating to liquidity facilities and to credit enhancements overlap (so that drawings under a liquidity facility could be deducted directly from the capital, i.e. as if they were credit enhancement). Could the Committee give further clarification in this area?

Clean break

At paragraph 504 there are a variety of conditions which an originating bank will have to meet in order to remove the relevant exposures from its calculation of risk-weighted assets (the "**clean break**", to adopt the terminology of the Financial Services Authority in the UK (the "**FSA**")). These require at sub-paragraph (b) that: "*the assets are legally isolated from the transferor in such a way (e.g. through the sale of assets or through subparticipation) that the credit exposures are therefore put beyond the reach of the transferor and its creditors, even in bankruptcy or receivership.*" Under UK law it is not possible through a subparticipation[1] to isolate the assets so that they are beyond the reach of the transferor's creditors in a liquidation of the transferor (so a lawyer would not be able to deliver the required opinion referred to at the end of sub-paragraph (b)).

A subparticipation is a contractual, back to back non-recourse funding agreement. Credit risk continues to be taken on the originating bank. However, we would argue that to the extent that this creates a risk it is a risk borne by the investor, not the originator.

The FSA recognises this by approving use of a subparticipation for the purposes of clean break in chapter SE of the Interim Prudential Sourcebook for Banks (paragraph 9 of section 5). The crucial point from the originator's point of view is that it has a fully funded position; it is no longer taking risk on the underlying assets and it cannot be subject to action by the investor except to the extent that it has received payments on the assets. We think that this should be a clean break for regulatory purposes. From the investor's perspective the continuing risk will be recognised by pegging the rating of the exposures to that of the originator's long term unsubordinated debt (as has been the case in the securitisations where this technique has been used). To the extent that legal isolation is needed the key is the nature of the limited recourse provision which would not allow the investor to claim on the originator except to the extent of monies received in respect of the underlying assets.

1 It should be noted that by contrast in the USA such a technique is effective to achieve such isolation. The legal systems differ in this respect.

We would suggest that this requirement is altered so that it is clear that the transferor is no longer taking risk on the assets following clean break, rather than the more severe test that the transferor's creditors could not have recourse to those assets in a bankruptcy of the transferor.

Credit enhancement increases

In many transactions the collateral is managed dynamically according to pre-ordained criteria. Those criteria are invariably set at a higher level than the criteria in relation to eligible financial collateral set out at paragraph 116 (not least because the collateral needs to meet AAA obligations). If the collateral performs better than anticipated then the additional revenue is sometimes distributed through the structure and sometimes held in a reserve account. However, if the collateral is downgraded then there are often requirements on the originator to renew it to the same value as at the inception of the transaction. This is more a matter of market risk than credit risk. Credit enhancement is being preserved rather than increased. It does not seem clear whether this would be permissible from paragraph 516(g)(ii) which states that an originator must not provide further credit enhancement after the transaction's inception.

Credit risk mitigation

We find paragraph 525(f) difficult to understand. This sets out a treatment to reflect the position where CRM is provided directly to an SPE. The proposals recognise that so long as the provider of the coverage is rated at A- or above then the risk weight will be based on the rating of the coverage provider rather than the underlying exposure. However, it makes little sense to discuss CRM in the context of obligations owed to an SPE itself since an SPE is invariably an obligor rather than a beneficiary. The obligations which will be the subject of such coverage would typically be obligations owed by the SPE to the investors – or a trustee acting on behalf the investors. For example, where a monoline guarantor gives a guarantee of the bonds it does so by guaranteeing the obligations owed to the investors not by giving a guarantee to the SPE itself.

The SPE will, of course, often receive credit enhancement direct from a regulated institution (as opposed to such enhancement being provided by tranching). Such credit enhancement could be construed as a CRM for the SPE in respect of the credit risk that the SPE is taking on performance of the underlying exposures. However, the SPE itself would be unregulated (so risk weighting would not be relevant to it) and the effect of the CRM would constitute credit enhancement for the obligations of the SPE under the relevant bonds. That credit enhancement would surely be treated in accordance with the rules for securitisation exposures set out at part IV D 3 and D 4? This treatment does not rest on the rating of the CRM provider but rather on the subordination of the CRM provider in comparison to the holders of the bonds and other creditors in the structure.

Synthetic securitisations

At paragraph 517(e) (synthetic securitisations) the proposals state that: "*the instruments used to transfer credit risk may not contain terms or conditions……that materially limit the credit protection or credit risk transference (e.g. significant materiality thresholds below which credit protection is deemed not to be triggered)*". Given the nature of a securitisation it is difficult not to insert some form of materiality threshold, otherwise protection would be triggered in "de minimis" circumstances. The present proposals seem to recognise that some form of threshold is acceptable - but they do not make it clear enough how "materiality" is to be measured. For example, one moment the proposals talk in terms of "materiality", the next in terms of "significant materiality". More clarity is needed here.

At paragraph 517(f) the proposals state in relation to synthetic securitisations that "*an opinion must be obtained from a qualified legal counsel that confirms the enforceability of the contracts in all relevant jurisdictions*". This strikes us as a very broad and imprecise requirement. While lawyers regularly deliver opinions in the securitisation market those opinions are subject to routine qualifications. For example, it is impossible to opine that a contract is enforceable without also pointing out that enforceability is subject to the general effect of insolvency laws on the rights of creditors - a qualification which would have to be made in these circumstances given that, like a subparticipation, a credit derivative contract does not remove the credit risk of the protection buyer. This matter can become complex in a cross border scenario. We are used to requirements for legal opinions in specific contexts (for example, the legal opinion required for clean break referred to above) but this context is not specific enough. Could the Committee please clarify its objectives? For example, is it referring solely to the credit derivative contract itself (a synthetic securitisation would typically contain at least two different types of credit derivative – see further below – as well as a variety of other contracts)? We would suggest that at the least the Committee should amend this condition so that it requires national supervisors to ensure that originators have evidence in their records that legal advice has been obtained in appropriate terms. That would seem more appropriate given that these provisions are concerned with operational issues rather than legal issues.

It is also unclear how the provisions set out in paragraph 517 relating to synthetic securitisations interact with those set out in paragraphs 162 - 165 in relation to the use of credit derivatives. In particular, in some synthetic securitisation structures the originator enters into an unfunded credit default swap with an SPE the activities of which are subject to appropriate restrictions. The SPE then issues credit linked notes to fund its exposure and invests the proceeds in highly rated collateral or cash. It will use such investments to discharge its obligations under the credit default swap, should the credit protection be triggered. If the credit protection is not triggered then it will use the investments to repay the investors. Such a structure will give the originator credit relief in the UK since its position is analogous to that of a beneficiary under a collateralised guarantee. However, under paragraph 165, an SPE would not be recognised for the purposes of capital relief since it would not have an appropriate rating. In this circumstance its rating should be irrelevant since risk is not being taken on the entity but on the assets which the entity owns. Given that the entity has no creditors other than the originator and the investors then there is no counterparty risk.

This problem is reinforced by paragraphs 517(c) and 545 which both state that banks may not recognise SPEs as eligible guarantors in the securitisation framework. However, at paragraph 544 the proposals state: "*collateral pledged by SPEs may be recognised*." The correct position is for SPEs to be recognised as eligible guarantors to the extent that their exposure is secured with eligible collateral as set out at paragraphs 116 and 117.

Mezzanine tranches

At paragraph 528 the proposals require that investing banks weight all BB+ to BB- positions at 350%, rather than 100% which would be the case if the investing bank were holding the exposure as a direct corporate credit exposure (see paragraph 40). This divergence continues: B+ and below should be directly deducted from capital. In contrast corporate exposures below BB- are rated at 150% or 100% if unrated.

We would make similar observations regarding the RBA material set out at paragraphs 581 to 585, i.e. that this approach seems to rest on an assumption that holding a tranche in a securitisation should by definition be more expensive than holding a tranche in an analogous underlying corporate exposure.

We appreciate that where the positions are unrated a deduction from capital is appropriate since risk remains within the system. However, the proposed approach in relation to rated tranches seems inconsistent. The Committee is intent on accepting rating agency methodology in one context, but rejecting it in another. It has also refused to contemplate regulating rating agencies even though it is using them to regulate the market.

There are further anomalies. For example, where an investing bank is using the simplified standardised approach (see paragraph 17 of the overview and annex 9) all securitisation exposures will be weighted at 100% even though the bank might have to deduct the same exposure direct from capital had it been using either the standardised or IRB approach.

Finally, a bank might well hold a mezzanine tranche in its trading book and attract far lower weightings – we do not see why holding an instrument with intent to trade should result in such a radically different treatment from holding an instrument to maturity.

Liquidity facilities

We note that IRB banks are subject to a CCF of 100% for liquidity facilities (paragraph 600) while those facilities are undrawn even if such facilities fall within the definition of an "eligible liquidity facility provider" as set out at paragraph 538. This seems a very harsh treatment given that under the standardised approach such facilities would only attract a 20% CCF. Why are banks with sophisticated credit systems being placed in a worse position than those which have more rudimentary credit systems?

Conclusion

In summary, although we think that reform is needed and we welcome the Committee's progress in setting down clearer rules in this area we think that some further revisions are needed. We recognise that securitisation presents unusual risks but we are concerned that the proposals go too far. One perverse result of the Accord was the incentive for banks to securitise their best assets and retain their more lowly rated ones on the balance sheet in order to maximise profits. However, this incentive will be removed by the new rules in relation to corporate risk – there is no need to go further and create higher risk weights for securitisation exposures merely because the assets have been securitised.

Securitisation remains a very useful tool for the diversification of credit risk and the maintenance of liquidity in the market. However, it is unlikely to continue to serve this purpose if these proposals go through as currently drafted.

Please contact Anthony Fawcett at the above address if you have queries.

Yours faithfully

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