November 19th, 2002

Secrétariat Général de la Commission Bancaire

To the attention of Mrs Sophie VUARLOT-DIGNAC

<u>Initial comments on the Basle II Second Working Paper on Securitisation</u>

Thank you for giving us the opportunity to submit to you our initial comments in respect of the Basel Committee's Second Working Paper on securitisation.

Our key concern for the new capital framework for securitisation is that it fully recognises the economic risk transfer effect of securitisation transactions and therefore allow us to use them efficiently as a risk management tool.

We recognise the progress achieved so far following Basel II first Working Paper on securitisation. We believe that there is still some way to improve the new framework in order to avoid creating disincentives to securitise and fully benefit of the reform to close the gap between the economic risk and regulatory capital charge for securitisation exposures. We see the proposed risk weights as still excessive but we welcome the Committee's increased recognition that securitisation does not create additional credit risk and wish that this could now be pushed further.

We are currently in the process of conducting the QIS 3 study for which we do not have the results yet. Therefore, please consider these comments as preliminary since we expect QIS 3 to give a more precise perspective on certain issues and highlight some others that we may not have identified at this stage.

1. Risk weight levels for securitisation exposures

We believe that some of the proposed risk weights or calculations may lead to excessive capital charge for securitisation exposures for banks as originators or investors, for both more senior and more junior tranches. Our internal models suggest that lower risk weights should be applied to securitisation exposures.

1.1 Super senior tranches

Empirical evidence has shown that synthetic tranches senior to a AAA rated tranche are less risky than the AAA tranche. Using the same risk weighting for the rated super senior and the AAA rated tranche below it, is therefore excessive.

On another hand, the proposed "look through" methodology that implies that the risk weighting of an unrated super senior tranche is given by the weighted average risk weighting of the underlying portfolio is also excessive.

In order to get an appropriate risk measure, this tranche clearly needs a specific treatment consistent with its high seniority. We propose to use a specific bucket with a specific risk weighting for the super senior tranche. This risk weight must reflect the fact that the sum of the capital charges allocated to all securitised tranches should be equal to the sum of the capital charge of the underlying assets.

1.2 Senior tranches

On the senior tranches, we recognise the progress made by the Committee allowing for reduced risk weights for senior tranches. However quantitative analysis shows that these risk weights should be even lower.

1.3 Junior tranches

Quantitative analysis of junior tranches also shows that risk weights are too high. Also, we would like to reiterate our belief that for other tranches there should not be a significant difference between ABS and corporate risk weights for securitisation tranches of the same ratings. Several workgroups[1] in the banking community are currently working on the subject and intend to provide substantiated evidence to support this. We would also welcome to have access to the Committee's own risk analysis and data on this aspect.

Both for the standardised and the rating based approaches, we still disagree about having a different treatment for originators and investors for lower rated tranches. We believe that such a treatment puts an unnecessary constraint on the originator who may in some cases still achieve a significant risk transfer while keeping the BB securitisation exposure.

Overall, we believe that the proposed rules would create a disincentive to securitise given that bank investors would be reluctant to invest in senior securitisation notes, or would have to price them at a higher cost than their economic risk, to compensate for the capital charge, while the capital cost for bank originators to keep them would be too high.

2. Calibration of the RBA and SFA calculations

Under both the RBA and SFA approaches, although we welcome the fact that originators' capital charge can no longer exceed Kirb, we believe that the deduction at the Kirb level is still excessive. We would like to see the cap further reduced by an amount as close as possible to the capital charge for the more senior tranches distributed to investors. This is based on the principle of capital neutrality which we understand has been accepted by the Committee and whereby a securitisation does not create additional credit risk. Hence, the sum of capital charges on all tranches of a securitised portfolio irrespective of their seniority and of their holder should not be different to the capital charge of the underlying assets before securitisation. Otherwise, we believe that there will be a double counting of the capital charge at the banking system level or beyond. Results of QIS 3 will be useful to quantify the extent of this double counting, but we fear it might still be quite substantial.

Furthermore we believe that securitisation risk weights, once properly calibrated based on the rating of each tranche (as discussed in section 1 above) should not be further adjusted by portfolio granularity and tranche thickness, given that these factors are already taken into account in the external ratings. On this issue we would welcome further explanation on paragraphs 20 and 28 as they appear to be contradictory. Indeed, for a tranche of a given rating, paragraph 20 suggests that a high portfolio granularity should reduce the RBA risk weight, whereas paragraph 28 explains that the marginal contribution to portfolio risk is higher for more granular pools and therefore a more granular tranche should attract a higher risk weight. We believe that these difficulties would have been avoided by allowing some type of "real" Internal Rating Based approach, at least for Advanced IRB banks, as those banks are likely to have internal models that would adequately measure the economic risk of these assets.

[1] The ESF Legal, Regulatory and Capital SubCommittee, to which BNP Paribas participates, intends to produce its comments by the end of December

Whilst SFA is inherently the most risk sensitive approach, we believe that the current rules and calibration of the SFA formula neither enable originators to fully benefit from it nor to be rewarded for the implementation of a sound risk management. Indeed under the current hierarchy of approaches the scope of the FSA usage would be quite limited. Also the combination of add-ons, floors and deduction of capital up to Kirb very much reduces the incentive to use it. Actually, first studies that quantitative workgroups are being conducting seem to suggest that the "pure" SFA formula may be a valuable tool to measure capital charges under hypothesis consistent with the overall IRB framework. However, the objective of risk-sensitivity of the SFA will not be achieved as long as the Committee wishes to introduce both a full deduction of Kirb and a capital floor:

- either all positions under Kirb are to be deducted from capital and there should only remain very low capital charges for positions beyond Kirb, if any (as we restate that capital after securitisation should globally be equal to capital before securitisation). One suggestion could be to allocate some percentage of Kirb to the positions beyond Kirb, instead of a fixed percentage of those positions themselves. Our conviction is nevertheless that the floor should be removed;
- or a floor (preferably reduced) is kept for positions beyond Kirb, materialising the level of risk the Committee considers to be effectively transferred to the owners of the considered tranches. Then there is no rationale in allocating the whole capital of the underlying assets (Kirb) to the positions under Kirb, and the principle of unconditional deduction should be removed in consideration of the level of risk transference.

Ultimately, banks should be given the flexibility to choose to use the SFA formula against the RBA approach not only in the very limited cases where there is no external rating for the tranches, but also consistently for all securitisations.

It is our understanding of the intention of the Committee that banks should be better rewarded for the implementation of IRB approaches as they necessitate the development of a more mature risk management system and process. For example, under the RBA approach, BB tranches should not be assigned higher risk weights than in the standardised approach. We believe that this incentive to move to more sensitive risk measurement would only be reached, as for the SFA approach, if the minimum capital charge for originators is allowed to go below Kirb provided that there is evidence of risk transfer to investors.

Finally, as the whole system lies on the supervisor's confidence in Kirb, we suggest that this advantage be only reserved for banks adopting the Advanced IRB approach, especially if the historical data on which their loss estimates are grounded have reached the required length, irrespective of any transition period.

3. Specific requirements for synthetic securitisation, credit derivatives, cash securitisation and convergence with IAS rules

3.1 Specific requirements for synthetic securitisation

Although we understand the regulator's objectives to ensure an actual risk transfer in securitisation and to avoid any implicit support from the originator, we are concerned about Pillar 1 being prescriptive in laying out unnecessary constraints and requirements for originators in the case of synthetic securitisation. We think that this may lead to the permanent exclusion of some useful features in securitisation structures, which may not go against the originator's interest to transfer risk. In an innovative market, severely constraining rules may significantly hinder the development of securitisation as an effective portfolio risk transfer technique.

Our opinion is that bank originators should be given the flexibility to incorporate innovative structuring elements in their transactions, and therefore Pillar 1 should not attempt to provide an exhaustive list of acceptable or "prohibited" structural features (which list can only be based on past structures). We believe that Pillar 2 provides the regulator the discretion if concerned to review the rationale of the securitisation transaction features and assess their efficiency in mitigating the credit risk for the securitised pool.

As an example, on early amortisation and clean-up calls, current language needs clarification on the different call definitions and their impact on the securitisation capital treatment. Nonetheless we believe

that early amortisation and clean-up calls provide the originator the flexibility to optimise risk transfer. Therefore we encourage a capital treatment of the call that would not take away or compromise the risk transfer optimisation. On the other hand, if the Committee would want to keep this language, structuring innovation in the future by 2006 or beyond would most certainly achieve the same results through different ways that the Committee would not have captured. Again, we believe that the legitimate concerns of the Committee as they arise, could be better dealt with under Pillar 2.

We also believe that section (b and d) of the 515, regarding ECAIs would need further clarifications. A bank should, for instance, not be required to always use the same ECAI for a given type of securitisations. If not, this will undoubtedly create monopolistic positions for some rating agencies and limit innovation and improvement in rating technologies. In addition, there is no justification for preventing banks from using "private ratings" as an eligible assessment. These ratings are usually not publicly available but disclosed to parties involved in the transaction. They are nevertheless assessed with the same methodology that applies for "public ratings" and therefore reflect the same level of risk. Regulators may exclude however from eligible assessments ratings which are not disclosed by rating agencies to any party of the transaction ("shadow ratings").

In respect of Pillar 2, we need further clarification on the regulator appraisal of the 2 major concepts which are 'implicit support' and 'significance' of a risk transfer.

As relates to implicit support, we believe there should be some language to ensure that implicit support would be deemed to have occurred, in order to avoid leaving this to the appreciation of the national regulators, which might create problems as relates to the level-playing field. Our recommendation is that this language should aim as defining the strategies (rather than specific features) that would be analysed by regulators to assess potential implicit support. For example, implicit support would be deemed to occur if the bank enters in any activity that would not be sensible from a risk/return perspective, and rather be favourable for the investors. Indeed, we strongly believe that securitisation tranches, as any other credit risk asset, should be actively managed after issuance, as market conditions and risk appetite may change, and that such active management, provided it is prudently conducted by the originating bank in a full understanding of risks and returns should actually be favoured.

As relates to the significance of risk transfer, please note that one of the objectives of securitisation is to hedge the unexpected losses which may be spread over the most senior tranches and that in some cases an already important risk transfer can be achieved with a limited portion of the notes being actually sold to the investors.

3.2 Convergence between Credit Derivatives and securitisation

Since Credit Derivatives and securitisation are similar credit risk mitigation techniques. They should therefore have similar capital charge treatment and impact both for banks that are buyers and sellers of protection. Therefore, the guidelines outlined under the credit derivatives section (paragraphs 170-173 of QIS3 Technical Guidance) need to be aligned with the securitisation section.

Regarding the operational requirements for credit derivatives we support the position that restructuring should not be included in the list of credit events to be specified. Our experience of restructuring triggers shows that as protection buyer we may be better off waiting for a failure to pay or bankruptcy credit event than going for an early restructuring trigger which may ultimately provide less protection. We therefore believe that in a majority of cases the cost of the restructuring clause is an unnecessary cost in our hedging transactions. Additionally, we see the restructuring risk as a migration risk, which we understand the regulator does not intend to offset with the capital charge and does not normally result in the bank writing a provision. Finally abandoning the restructuring clause would help avoid any potential conflict of interest between the seller and the bank that buys the protection, which may be involved in the restructuring discussions with its client.

The new capital accord framework makes an extensive use of ratings. We appreciate it as an opportunity to broaden the scope of instruments used as eligible collateral as ratings are consistent across different families of instruments. The operational criteria for securitisations will need to include rated debt securities issued by SPEs as eligible collateral. These securities bear the same level of risk as any similarly rated debt securities issued by corporates or banks and should therefore be eligible.

3.3 Cash securitisation

Regarding the treatment of liquidity facilities, we believe that some clarification is needed. Some of the conditions which would trigger a 'credit support' seem unclear and could lead to unjustified penalisation of some transactions.

3.4 Convergence with IAS

As we understand that IAS and Basle II rules may converge at some stage, we would be happy to obtain clarification from the Committee on the issues where apparently inconsistent different treatments exist. Namely, a main concern for us with IAS rules at this stage is that an extended use of fair value accounting of hedges would create some P&L impacts from the hedging transactions, which may ultimately hinder synthetic securitisation and credit derivatives from being widely used as portfolio credit risk mitigation techniques. The industry will be actively promoting ways so that hedge accounting may be more adapted in the IAS rule, but the Committee should be aware that some of this work may translate into new definitions of credit events or settlement terms, which in turn, are likely to lead to further discussions on the Capital Accord, so that the Accord reflects the evolution of industry standards.

As a result, we would urge the Committee to communicate the timing for further discussions on the Second Working Paper on securitisation and extend it to a period allowing both to take into account the results of QIS 3 and the ongoing discussions with accounting bodies, before any definitive text is produced.

We thank you again for the opportunity to discuss these important issues, and remain committed to contribute to further work in the various forums that address these matters.

Yours faithfully