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Secretary
Board of Governors of the
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20th Street and Constitution Ave., N.W.
Washington, D.C. 20551
Docket No. R-1154

Robert E. Feldman
Executive Secretary
Attn: Comments
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Corporation
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Attention: Docket No. 03-14

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attn: 2003-27

Re: ANPR: Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord

The American Securitization Forum[1] thanks the member agencies (the "Agencies") of the Federal Financial Institutions Examination Council for this opportunity to comment on the Advance Notice of Proposed Rulemaking (the *"ANPR"*) relating to the implementation of the Basel Capital Accord (the *"Accord"*) in the United States. We refer to the proposed Accord set forth in the ANPR as the *"U.S. Proposal"*.

The securitization industry has developed as a large market that provides an efficient funding mechanism for originators of receivables, loans, bonds, mortgages and other financial assets. The industry performs a crucial role by providing liquidity to nearly all major sectors of the global economy including the residential and commercial mortgage industry, the automobile industry, the consumer credit industry, the leasing industry, the bank commercial loan markets and the corporate bond market. Additionally, securitization has provided a means for banks to effectively shed portions of an asset's credit and other risks by transferring those risks to other regulated banks as well as other non-regulated institutions who have an appetite for such risks. To the extent that true economic risk has been transferred by a regulated entity to a third party, the capital requirements for that regulated entity must also be commensurately reduced.

While a properly revised U.S. Proposal has the potential to move regulatory capital requirements in the right direction, we continue to hold fundamental concerns with the proposals. We believe these concerns must be addressed if the Agencies are to achieve the

[1] The American Securitization Forum (the "ASF"), an adjunct forum of The Bond Market Association (the "Association"), is a broadly-based professional forum of participants in the U.S. securitization market. Among other roles, the ASF members act as issuers, underwriters, dealers, investors, servicers and professional advisors working on securitization transactions. The views expressed in this letter are based upon input received from a broad range of ASF members including members of the ASF Regulatory Subcommittee. More information about the ASF, its members and activities may be found at its internet website, located at www.americansecuritization.com.

stated goals of the revised Accord without disrupting the liquidity and risk dispersion roles that securitization now performs. We believe the Committee is moving in the right direction with their announcement that they are looking for ways to simplify the revised Accord for securitizations and hope that the Agencies will continue to work with the Committee to achieve this goal.

We believe that the U.S. Proposal, if adopted for securitization as proposed, will in many instances result in regulatory capital requirements that diverge from accurate economic capital calculations. The result of this will be to motivate a bank to make decisions that are not based on a sound economic analysis of transactions or consistent with the risk management frameworks used by regulated entities and supervised by the regulators pursuant to Pillar 2. Simply put, we believe the U.S. Proposal would perpetuate, albeit in a different form, capital arbitrage issues that were among the primary reasons for the currently contemplated reforms.

Our comments are intended to highlight six key areas where we believe modifications are necessary to allow for a more appropriate alignment of risk and ***minimum*** required capital. These areas are as follows:

(i) We believe that the risk weights under the RBA are too high in many critical areas. Our discussions of this issue are in Part 1 of this letter. Page 3.

(ii) Notwithstanding the October 11, 2003 announcement that the Basel Committee on Banking Supervision (the "*Committee*") is considering eliminating the supervisory formula for asset securitization, we provide a number of suggestions to improve the SFA, which are set forth in Part 2 of this letter, although we continue to believe that the internal bank rating system is the best approach for ABCP conduits. Page 7.

(iii) We believe that the current proposal does not present a workable internal approach for the calculation of capital for ABCP conduit facilities and that the resulting capital requirements significantly overstate the risks of these facilities. We outline our concerns over the problems inherent in the current approach, along with alternatives that we believe will result in more appropriate capital requirements in Part 3 of this letter. Page 10.

(iv) We believe that it is appropriate to have a cap on capital held by an originator after a securitization at the level of capital required if there had not been a securitization. We discuss this in Part 4 of this letter. Page 22.

(v) We think that the current proposal unduly penalizes synthetic securitizations and we highlight the reasons that cause the problems in the current proposal in Part 5 of this letter. Page 22.

(vi) We believe that the current proposal should be revised to give credit for first loss exposures that are being created in the United States to comply with FIN 46. This issue is discussed in Part 6 of this letter. Page 23.

In addition, we make several technical suggestions in Appendix B of this letter. Although we believe that these suggestions should not be controversial, we note that we feel the proposed changes are critical if the proposal is to work in a practical and realistic manner for securitization transactions.

Although we have tried to organize our discussion of these key points in a logical fashion, the order of presentation is not indicative of our priorities on these issues. We believe that all issues presented are of equal importance.

1. **Calibration of each of the proposed risk weight standards under the RBA is too high at many critical levels**

We believe that the risk weights applied to most securitization positions under the RBA are too high based on the evidence we and others have reviewed showing the risks of these positions. We feel that there are a number of reasons leading to the risk weights that have been proposed which we will address below. First, we understand that the risk weights under the RBA were mainly based on an analysis of CDO and corporate exposures, which we believe results in too much capital for other asset exposures. We also note that capital is most excessive for senior tranches of securitizations, including senior tranches of CDO and corporate exposures. Second, while we understand the Agencies' intended use of appropriately conservative assumptions to deal with uncertainty for regulatory purposes, we believe that several assumptions are unreasonably conservative, the cumulative effect of which has led to unjustifiable and punitive capital requirements for securitizations.

We believe that the U.S. Proposal will make securitizations less efficient for regulated originators and regulated investors alike (in comparison with their unregulated counterparts) resulting in fewer effective risk dispersing transactions. To address these concerns, in Paragraph 1.C. below, we propose further analysis to refine the RBA approach.

In addition, in order for the rules to produce correct results, there must be sufficient flexibility within the final U.S. Proposal for a regulator to adjust the framework set forth therein in circumstances where the regulator feels differing treatment is appropriate after discussion with a bank on particular issues on a transaction-by-transaction basis.

(A) *Calibration of the proposed risk weight standards amongst different asset classes is too high*

We understand that the risk weights under the RBA were mainly based on an analysis of CDO and corporate exposures. We believe the overall approach used results in excessive capital for all senior positions (including CDO and corporate exposures) and at most other levels for retail asset exposures.

During the preparation of the comment letter dated July 31, 2003, submitted by a joint working group of which we were a part (the "Joint Basel Comment") to the Basel Committee on Banking Supervision, the quantitative group of the ESF examined empirical evidence relating to three distinct categories of retail asset classes. We submit with this letter a copy of the quantitative group's analysis and conclusions herewith. We agree with the conclusions of the quantitative group that the evidence indicates that the RBA requires too much capital across all asset types and at virtually every ratings level.

(B) *Appropriate assumptions for calibrating the required capital under the RBA*

We are concerned with the use of a methodology that assumes that a particular rating has a particular EL (and LGD) regardless of the thinness or thickness of a tranche assigned such a rating. Perraudin and Peretyatkin describe their rationale for using this approach in their paper. They clearly understand the importance and impact of the assumption, and make arguments for their assumption that are quite valid. Their approach and rationale are perhaps best illustrated in the CDO market. CDOs have, among other things, two characteristics that generally lead to the conclusion that the Perraudin and Peretyatkin approach is reasonable. First, the underlying collateral is generally rated with significant amounts of performance history as it relates to loss, PD's and LGDs. Second, structuring tends to follow the Moody's approach that sets EL constant per rating category. To the extent that this approach is applied to transactions that are relatively thin and carry lower ratings, we find that the results generally make sense. However, we note that the Perraudin and Peretyatkin approach introduces substantial distortions for transactions that are driven by other types of ratings methodologies or represent substantial portions of the capital structure (i.e. thick tranches).

The securitization market has equally embraced Standard & Poor's and Fitch as experts in rating securitization transactions and very often Standard & Poor's and Fitch are asked to rate deals along with Moody's. Consequently, the securitization market and in particular the senior tranches of the securitization market can often solve for the "lowest common denominator" credit enhancement requirement among the various rating agencies. In cases that involve S&P or Fitch, the credit enhancement level will involve a "first dollar of loss" approach and, as a result, a PD-based ratings methodology. This introduces significant capital issues if we are meant to capitalize these positions based on a Perraudin and Peretyatkin approach. The

obvious result will be an excessive capital requirement for senior positions which have the same rating (and PD) but have a far smaller EL.

As a result of the assumption of a constant EL in the Perraudin paper, the model assumes an LGD of 50% for senior positions and a PD that is consistent with the PD for a like-rated corporate asset. We do not believe that an assumption of 50% loss in a senior securitization tranche is supportable. In the world of non-CDO securitizations, the EL (and LGD) of a position will vary dramatically based on whether it is senior or subordinated in the structure of the transaction as well as the credit enhancement attachment points. Our data suggests that the expected LGD for senior tranches is significantly less than 50%, indicating a lower capital requirement from that proposed by the Agencies.

Working with sample transactions, we have developed distributions of LGD's for senior positions. We can show that with 99.9% confidence, a senior single "A" rated auto loan tranche would have an LGD of less than 6%. Similarly, we can show that with 99.9% confidence a single "A" rated residential mortgage/home equity securitization would have an LGD of less than 10%. The expected LGD's are a small fraction of these values: less than 2% for the auto loan position and less than 5% for the home equity position. Given the "EL-constant" approach followed in the paper, the Perraudin model calculates capital for these transactions that is a multiple of the appropriate value. This is because, while the PD assumed may be in the ballpark, the LGD assumed for these positions is 50%. Given the fact that the actual LGD in these cases might be less than 1/10th of the value assumed in the model, we come to the conclusion that the capital allocated for senior non-CDO positions by the model in the Perraudin paper is at least 3 times too high. Graphs depicting the relationship of LGD to tranche thickness are attached in Appendix A.

We believe that it is important that the RBA be recalculated using the Perraudin and Peretyatkin model but changing the key LGD assumption previously used for calibrating risk weights for granular highly rated tranches that qualify for risk weights calculated in column 1 of the RBA table. Again, while the ideal would be different assumptions for different asset classes, we believe an appropriate LGD assumption that is workable across the board for these thick, granular positions is one between 5% and 10%. We would be happy to work with the staff in the rerunning of the model to the extent our assistance is needed. We believe that the recalibration after appropriately altering this one assumption will result in significantly less required capital for senior positions consistent with the historical performance of these positions.

We understand that the Perraudin and Peretyatkin model discussed above was just one of many factors used by the Agencies in determining the calibration of the RBA. We have focused on this factor primarily because we are not privy to other factors and assumptions used in setting forth this proposal. While we have primarily

focussed on column 1 in this letter, we believe that we should have the same opportunity to review the assumptions and modelling done to derive the risk weights in the other columns under the RBA so as to comment on the validity of the risk weights proposed in those columns as well. We firmly believe that all assumptions and factors used to calibrate the risk levels for each column of the RBA table should be published and debated in an open public forum to allow for input from a broad range of experts in this area. We do not believe that revisions to the regulatory capital requirements without this level of transparency in process will lead to legitimate results.

(C) *Limitations on Deductions from Capital under the RBA*

We do not believe that it is appropriate to require a deduction from capital below BB- levels for investors and for all positions within Kirb for originators. While we concede that it is appropriate to conservatively treat true first loss positions, we believe that both originators and investors should be able to use a risk weight based on the RBA approach for any rated position that is not such a true first loss position. We believe that credit must be given for positions that have the benefit of credit enhancement, whether through the subordination of another position or through the existence of excess spread or other credit enhancement not currently recognized under the SFA.

The fact that it is an originator who holds such a position does not make the ratings for that position unreliable; there is no difference in the risk associated with a particular position simply because it is retained rather than acquired. Provided the final RBA risk weights will be correctly calibrated, application of the RBA to a rated position that is not a true first loss position should result in the appropriate amount of regulatory capital being held, regardless of who is taking the position or at what level such position is rated.[2] To address concerns that a bank might "cherry pick" between the RBA and the SFA (or under our proposed internal approach) by choosing to have a position rated or not, we would also propose that banks be required to adopt a policy setting forth consistent terms upon which it will determine to have a position rated or not.

(D) *Further Changes to the RBA*

We believe that there needs to be additional analysis completed by the Agencies prior to the finalization of the U.S. Proposal to address the appropriate calibration of risk

[2] We note the logic of equal treatment of all holders of rated positions is recognized by the US regulators in the new "Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Capital Treatment of Recourse, Direct Credit Substitutes and Residual Interests in Asset Securitizations", Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision, effective January 1, 2001.

weights for the RBA. We will make ourselves available to the extent there are areas in which we can provide assistance to the Agencies in this analysis.

We refer you to the analysis done by the quantitative group for our Joint Basel Comment and concur with the recommendations for separate ratings tables for different asset classes proposed therein.

Additionally, we believe that the RBA should be recalibrated to (i) make an adjustment of the risk weights for thick senior tranches to reflect the markedly lower risk of these positions and (ii) result in risk weight levels based on *appropriately* conservative assumptions that more accurately reflect the evidence of the risks at each level.

We note that we believe it should be left to individual regulators' discretion, after consultation with a bank, as to where asset types that do not fit neatly into one of the asset classes (such as trade receivable transactions) proposed in the Joint Basel Comment should be placed. We believe the complexity of separate RBA tables for each of the five primary asset classes will more than be outweighed by the benefits of the accuracy of separate categories of risk weightings.

2. **Issues with the SFA**

As discussed in Paragraph 3.B. of this letter, because of the problems in applying the top down approach, we believe that an internal bank rating approach should be adopted for liquidity and credit enhancement positions for ABCP conduits. If the Agencies were unwilling to adopt such an approach, and for other unrated positions that would continue to be subject to the SFA, we have the following specific comments on the SFA approach.

(A) *The floor capital charge is too high*

We suggest that rather than a floor for each transaction, the floor capital requirement under the SFA be a floor for an overall portfolio. First, a portfolio-wide floor gives a bank continued incentive to continue to structure highly rated, very safe transactions on a transaction by transaction basis. Under the proposed deal by deal floor, there will be little incentive to structure tranches to ratings levels beyond which the floor overrides the actual risk of a position. Second, recognizing that any floor is arbitrary, a portfolio-wide floor imposes only one conservative assumption rather than the multiple conservative assumptions in a deal by deal analysis. We believe a portfolio-wide floor significantly reduces the distortions that are inevitable when any arbitrary floor is imposed but continues to provide a means for regulators to maintain an appropriately conservative minimum regulatory capital requirement. For the same reasons we advocate a lower floor below, we believe that an appropriate portfolio-wide pool should be no more than half of the 56 basis points originally proposed. We believe that the historical performance of securitizations, particularly liquidity

positions for ABCP conduits, indicates a floor much closer to 0 basis points than 56. While we continue to believe that any floor should be more closely calibrated to the actual risks of a portfolio, we suggest a floor of 25 basis points is more consistent with actual risk than 56 basis points.

If the Agencies were not to accept a portfolio-wide floor, we believe that the current floor proposal is so high as to cause great distortions between what are meant to be minimum capital requirements and economic capital held by a bank. In connection with drafting this letter we surveyed several banks involved in the preparation of this comment to determine the level of economic capital they would hold for positions with a term of 2-3 years at the AA level and at the AAA level. The results of this survey show that the floor will generally cause minimum regulatory capital requirements to diverge from economic capital requirements at the AA level.[3] While the floor does not appear to grossly overstate economic capital for all types of transactions (variations exist based on deal size, industry and maturity), our limited sampling shows that in some instances the floor would require nearly double the economic capital a bank holds against short term AA rated positions. As you can imagine, the distortions are more significant at the AAA level. Simply put, the proposal as adopted takes away virtually any incentive to structure transactions to safer more highly rated levels.

We understand that the RBA risk weight for AAA granular pools is one factor used to calibrate the floor under the SFA approach. As discussed in Paragraph 1, we believe that these tranches should attract capital that is a fraction of that suggested by the current RBA risk weights and therefore the floor under the SFA should also be calibrated at a fraction of the 56 basis points proposed. The floor should only serve to override actual risk weight calculations at the AAA level--and then only in a manner that does not significantly distort minimum capital requirements from prudent economic capital calculations.

(B) *Additional Credit for Future Margin Income*

In the U.S. Proposal, the Agencies have recognized and given partial credit to the sizing of revolving retail asset securitizations to create an expected level of future margin income being available to cover expected losses on the portfolio. We note that securitizations of other interest-bearing assets have the same structure and expectation of available future margin income as retail exposures. For example, when securitizing auto loan receivables, gross portfolio yield to cover losses in one bank's recent sample of transactions of this type was approximately 950 bps per annum on average. For insurance premium finance receivables, the average gross yield used to cover losses was approximately 850 bps per annum. In addition, the actual level of gross yield may vary significantly from one portfolio to another,

[3] As we did not survey for economic capital at lower ratings levels, our conclusions should not suggest that there is not divergence at these lower levels for some transactions.

indicating the sizing of the excess spread to reflect the varying risks of each individual portfolios (i.e., higher risk portfolios would be expected to have more excess spread to cover higher expected losses).

We believe the Agencies should give credit to all asset classes where the yield on the assets is used to cover expected losses.[4] We concede that any such approach should be restrictive enough to only provide credit where credit is due based on the structure of the transaction. In securitizations with future margin income, transaction structures may differ significantly and in some cases the financing institution would not be entitled to any of the excess spread on the portfolio (for example in cases where the excess spread is returned to the seller of the receivable pool). Only that portion of the future margin income, if any, that exceeds ongoing transaction expenses (i.e., the excess spread) should be given credit as credit enhancement.

We also believe the Agencies should expand the credit given for the existence of future margin income to all transaction types structured to allow for excess yield (future margin income that exceeds ongoing transaction expenses) on assets to serve as credit enhancement to cover expected losses. We note that rating agency methodology, the cornerstone of the RBA, gives credit for the existence of such credit-enhancing excess spread structures. In fact, many times in transactions where excess spread is used to provide protection against losses, the second form of loss protection (e.g., overcollateralization) will be required to be sized much smaller than it would otherwise need to be in order to cover losses. For the SFA to accurately assess the risks of these transactions and provide consistency between the RBA approach and the SFA, the SFA must recognize this form of credit enhancement in all transactions where it exists.

(C) *More Appropriate Treatment for Dilution Risk*

The U.S. Proposal treats dilution risk extremely conservatively. The current proposal does not give any credit to contractual recourse to the seller for dilution in asset types such as trade receivables and credit card receivables where dilution risk is relevant. This is contrary to rating agency and industry practice that acknowledges that contractual recourse for dilution is the risk equivalent of an unsecured loan to the seller of the receivables. The U.S. Proposal dictates that when calculating capital for asset pools that have dilution risk, there is a requirement to use the expected loss from dilution as the PD and 100% for LGD which results in a grossly overstated Kirb.

The 100% LGD assumed in the U.S. Proposal for calculating dilution risk under the SFA is inappropriate. First, dilution risk, unlike most forms of credit risk, is not only mitigated by the presence of recourse to the seller of receivables to cover dilution

[4] If the Agencies were to adopt an approach that only looked at unexpected losses, we believe that credit should not be given for any portion of the yield that is to cover expected losses.

losses but also, in many cases, by reserves sized as a multiple of expected losses to cover both EL and UL. This seller recourse is a meaningful and material risk mitigation tool and should be acknowledged as equivalent risk of an unsecured loan. Additionally, in connection with the preparation of this comment, JPMorgan Chase Bank reviewed 18 pools of trade receivables to measure the ratio of Kirb to the overcollateralization levels required by S&P rating methodology for Single-A rated liquidity facilities. The measurements were made for credit and dilution components separately. They found that the dilution results are systematically higher (average Dilution_Kirb / Dilution_OC = 176%) than the credit results (average Credit_Kirb / Credit_OC = 74%). The chart attached hereto as Appendix C indicates the ratio results for these 18 facilities. Assuming the S&P methodology is valid, these results suggest that the Basel standard for dilution losses is significantly higher than for credit losses resulting in an overstatement of capital for dilution risk.

We continue to work on alternatives to the current proposal and will present these to you as they are developed.

(D) *More Appropriate Parameters for LGD*

To apply the top down approach a bank must decompose expected loss ("EL") into its probability of default ("PD") and loss given default ("LGD") components. If these numbers cannot be derived in a "reliable" manner, extremely conservative proxies of PD and 100% LGD and EAD assumptions must be applied. It is likely that banks relying on the top down approach would be required to use these conservative assumptions. We suggest that a revised top down approach provide a table of LGD parameters for securitizations rather than an LGD being equal to 100%. We suggest that this table be delineated by asset class.

3. **Calculation of required capital for ABCP conduit facilities should be improved**

Our principal concern relating to the application of the U.S. Proposal to asset-backed commercial paper programs is that we do not believe that it provides a viable method for effectively measuring required capital for ABCP positions, particularly liquidity and program wide credit enhancement positions, under the A-IRB. In order to use the RBA, banks would have to have liquidity and credit enhancement facilities externally rated. The ratings process would be time-consuming and add costs for each transaction while providing relatively little benefit given the relatively low risk of a liquidity facility, infrequency of draws and very low losses under these facilities historically. Based on the treatment of sponsors as originating banks as currently proposed, even the RBA does not preclude the complicated SFA calculation of Kirb in as much as a liquidity or credit enhancement provider would also be required to calculate Kirb to determine whether a position falls above or below Kirb. From the perspective of a liquidity and credit enhancement provider, the SFA, in its current form, is a complicated, burdensome and unworkable

approach that has the real potential to result in an overstatement of the minimum levels of capital for exposures to ABCP conduit facilities.

We believe that the actual risks of both liquidity and credit enhancement exposures are relatively small and both should qualify for required capital at the supervisory floor. Based on the results of QIS3, we are concerned that significantly more capital than the floor may be required to be held for these exposures. This capital is in excess of a floor that we have already argued was itself excessive.

In our view, that the top down approach leads to capital for these positions above the supervisory floor is more indicative of the fundamental flaws in the top down approach than of the risk of these positions. Our concern with the top down approach is the implication that deals cannot be structured properly, nor monitored adequately, without access to prescribed information, which is either not tracked or often confidential or proprietary data. Industry performance bears witness to the fact that deals have been successfully structured for years without such prescribed information. The Agencies have developed a complicated methodology using prescribed data that may not be relevant to the determination and monitoring of a risk of a transaction. This top down model is inconsistent with the approach utilized by the market, which has developed a model based on EL, in which EL is used to size credit enhancement to a particular ratings threshold using portfolio performance data as currently tracked and reported.

We believe that the regulatory concern over the validation of internal systems in this area is unwarranted. Banks' internal systems have been developed over many years and are subject to rigorous independent third party validation as well as subject to periodic regulatory review. The validation now in place provides for reviews of the reliability of the inputs that go into a bank's internal model, the accuracy of the operation and calibration of that model, the bank's policies regarding the frequency of testing of a portfolio and a number of other critical areas of the operation of a bank's internal system. In contrast to the top down approach, there is a strong validation system currently in place that would be at the disposal of regulators.

We hope that our suggestions below provide the Agencies with viable alternatives to the current approach that balance both regulatory concerns with our concern that the revised U.S. Proposal more closely calibrate the risk of a transaction.

(A) *Issues with the top down approach*

Quite frankly, we do not believe the top down approach works for ABCP conduit transactions. Although the top down approach is meant to provide an alternative to the bottom up approach, we have found it to be very complex, costly and inaccurate, in major part because it is not reflective of the way the conduit business operates. In particular, the top down approach overstates appropriate capital as a result of layers of overly conservative calculations, the attempt to use performance data in ways that

are unworkable and the lack of credit given for many structural enhancements found in conduit transactions.

The costs and burdens necessary to both fix the top down approach as well as to modify systems to be able to apply a top down approach in practice are significant. While the increased cost could be justified if the resulting analysis resulted in a corresponding increase in the accuracy of the risk analysis, we do not believe the top down approach provides such a result. Given the success of the methodology currently employed by banks to analyze and structure conduit transactions, as measured by the successful track record of the business, the imposition of the radically different and untested top down approach is unwarranted. For these reasons, we continue to strongly encourage the adoption of an internal bank rating approach described in Paragraph 3B. below. The balance of this paragraph is meant to highlight our core issues with the top down approach.

To apply the top down approach a bank must decompose expected loss ("EL") into its probability of default ("PD") and loss given default ("LGD") components. If these numbers cannot be derived in a "reliable" manner extremely conservative 100% LGD and EAD assumptions must be applied.

First, many originators, themselves, do not track the information necessary to provide to a bank that would permit the bank to calculate the PD in the manner or at the level contemplated by the top down approach much less the bottom up approach. Often, an originator will track the EL of a pool, not the PD and LGD of that pool. This is not meant to suggest a bank does not reliably track pertinent pool performance statistics that are linked to important protective triggers.

Second, in those situations where the originator has the necessary level of detail needed to "reliably" segment PD into bands, it is highly unlikely that such detailed information would be shared since it is often subject to confidentiality requirements that prohibit information sharing or is considered highly confidential proprietary information by the originator of the assets.

Third, even if an originator were able to share the information, the detailed reporting required could greatly diminish the attractiveness of an ABCP funding alternative—the Agencies are asking not only that banks change the way that they do business, they are also asking banks' customers (who may not be regulated) to change the way they do business as well.

Consequently, lacking the detail necessary to decompose EL into is PD and LGD components in a reliable manner, sponsors and other providers of liquidity and credit enhancement positions to multi-seller conduits would need to develop an appropriately conservative "proxy" methodology to derive a PD from reported data. It is inevitable that such an exercise would be open to wide interpretation.

To derive Kirb using the top down approach, these conservatively derived proxy PDs, would then be fed along with conservative LGD and EAD assumptions into Kirb model worksheets. Embedded in the Kirb worksheets are conservative risk assumptions regarding the underlying asset type, as well as unequal treatment of future margin income ("FMI").

Models are particularly conservative when assets are anything but short-term revolving consumer assets in large measure due to the treatment of FMI. FMI, together with capital, protects banks against insolvency. While the function of FMI for qualifying revolving retail exposures on the bank's balance sheet is recognized and the model allows 75% of a particular estimate of future margin income to be included as a deduction in the capital formula, such FMI treatment is not accorded to other retail assets.

Varying kinds of collateral, notably consumer installment loans and auto loans, resemble short-term revolving consumer assets in offering credit protection in the form of wide margins. Thus, the rationale for recognizing the beneficial effect of FMI for short-term revolving consumer assets applies equally to these other cases; however, such beneficial effect is not equally recognized under the present Accord.

The impact of such unequal treatment of FMI can be seen in an example involving high-quality consumer installment loans. Kirb calculated by one bank using the category 2a worksheet (non-mortgage retail - not including qualifying revolving exposures) was 70% higher than the Kirb calculated using the category 3a worksheet (non-mortgage retail – qualifying revolving exposures).

Since the economic substance is the same for both revolving and non-revolving consumer credit products, the capital rules should allow a deduction of estimated future margin income for both revolving and non-revolving consumer credit products, that is, equal treatment for equal substance.

Next, after the underlying portfolio's risk is quantified in the form of Kirb, the required capital for a particular position is determined by layering the tranches of credit enhancement in order of seniority. This layering process, however, ignores many of the structural protections that both the rating agencies and the market have accepted as legitimate credit enhancement tools. For example, sufficient credit will not be given to unfunded reserve accounts or locked-in excess spread. Furthermore, this process does not take into account a myriad of structural protections that do not lend themselves to quantification.

Finally, as discussed in paragraph 2C above, the U.S. Proposal treats dilution risk extremely conservatively.

The effect of the multiple layers of conservatism built into the top down approach is an overstatement of Kirb and can be seen in the results of two transactions. The use

of the top down proxy approach led to a near doubling of Kirb as opposed to the Kirb calculated using the bottom up approach in a credit card transaction modeled by one respondent bank. In this example, the bank used an annualized average gross charge off number as the proxy for PD and a 100% LGD, assuming it could not "reliably" breakdown EL into its component parts. This same doubling was seen in a trade receivables transaction when the approach was applied by a different bank.[5] It seems unduly harsh to double the required minimum capital for a position because a bank does not track performance data in the manner proposed by the U.S. Proposal.

Of concern are the results of QIS3 that indicate that the top down approach as currently formulated would lead to deductions from capital for a portion of many liquidity and program credit enhancement commitments. This grossly exaggerates the risks of these positions, particularly liquidity commitments as evidenced by their historically low probability of draw and low losses.

We strongly urge the Agencies to recognize that, because of the flaws mentioned above, the top down approach as currently proposed does not "prove" a facility is more or less risky and cannot assess required capital of liquidity or credit enhancement facilities in a sufficiently risk-sensitive manner because it does not appropriately analyze performance data within the context of a securitization transaction. The time that would be required first to fix the top down approach and second to attempt to adapt both banks' and their customers' systems to accommodate the approach is not warranted given the existence of a proven method of estimating the risk of a pool and structuring transactions to desired credit enhancement levels.

(B) *Internal ratings approach should be available*

Because of the problems inherent in the proposed top down approach and for the reasons discussed below, we believe that banks should be permitted to produce their own internal ratings and systems, an internal bank rating approach, to determine required capital for liquidity and credit enhancement positions supporting ABCP conduit transactions so long as the position is investment grade. We believe this approach allows for a more robust validation process based on the long history over which the internal ratings methodologies have been used.

We understand that there is a concern with how to validate a bank's internal ratings system. We submit that a far greater concern should be how to validate the SFA, a system that is not only complicated, but untested and novel to banks and regulators alike. For reasons discussed below, we believe that a bank's internal system for rating ABCP conduit transactions is a superior alternative than the SFA.

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[5] See page 18 and accompanying calculations in the presentation dated October, 2003, submitted to the Agencies by JPMorgan Chase Bank.

First, we do not understand why the Agencies are willing to rely on a bank's internal calculations related to corporate and other exposures but not securitizations. In rating corporate exposures, banks take into consideration a variety of complex factors, including making diversification and correlation assumptions in the corporate context. In many ways, the internal rating of a corporate exposure requires more complicated analysis than a structured asset-backed exposure. We have heard that regulators are concerned about a bank's ability to address correlation for securitizations in its internal systems—we do not understand this, especially in light of the fact that regulators appear to believe that banks can appropriately address correlation in other contexts, such as for corporate exposures. If a bank is using methodology that is consistent or more conservative than rating agency methodology by definition that bank is addressing correlation to the same degree as a rating agency. For example, there are geographic and industry concentration limits in certain models (e.g. mortgage securitizations) that attempt to minimize correlations along location and business lines.

Internal ratings systems relating to ABCP conduit transactions are currently designed to be consistent with, and in many instances more conservative than, rating agency methodology. This publicly available rating agency methodology is well established for the primary asset classes and securitization structures. Furthermore, the methodology is not complicated—it is based on structuring transactions to cover various multiples of historical loss and, in relevant cases, dilution levels. Whether a bank's system is consistent with rating agency methodology is easily verifiable by internal auditors, third party auditors and regulators. This validation can be done directly by comparing the publicly available methodology with that used in an internal system. Indirect validation can also be done by comparing the internal rating assigned to a position with that assigned by a rating agency in the same position or to a similar transaction of the same asset type in the term market. Consistency between an internal system's rating and an external rating of that or a comparable transaction, which we believe you will find to be the case, further supports the validity of an internal bank system.

Bank's internal systems have been built and updated within banks based on constant analysis of data over many years and rigorous systems of internal review. First, a bank's internal system was initially designed, in many cases a number of years ago, to assign internal ratings consistent with rating agency methodology. Beyond merely establishing an internal ratings system, a bank's internal system also sets forth limitations on concentrations of levels of transactions at various risk levels and other portfolio parameters designed to limit a bank's risk exposure. These systems are subject to review by internal credit risk assessment departments that are separate from a bank's origination and portfolio management departments. Just as the rating agencies track ratings migration and other market developments to adjust their ratings criteria, so too do banks with their internal systems from time to time. Second, transactions are also monitored on a periodic basis—more frequently

(monthly, weekly or even daily, as appropriate) at the transaction and portfolio management levels, but also by internal credit risk departments. This review looks at all aspects of a transaction, including monitoring of transaction and customer ratings, servicer compliance and portfolio performance. A rating can be reviewed if the periodic review of a transaction suggests such a review is warranted and is also generally formally reviewed by internal credit risk departments at least annually in connection with the annual renewal process for a 365-day liquidity facility.

We propose that if a bank were to adopt a system-wide or transaction level standard that is materially less conservative in any material portion of its analysis than rating agency methodology,[6] such variances would be subject to internal bank review. We believe that the instances when a bank would be less conservative on a given transaction than rating agency methodology will be very rare--there is little incentive for a bank to go out on a limb and arbitrarily lower its standards. If there are extenuating circumstances, there would an extensive review by a number of internal constituents, including risk management. Ultimately, the internal system, including its procedures for exceptions to rating agency methodology, will remain subject to regulatory review.

Finally, these internal systems are those with which regulators have the most familiarity—they have been in place and subject to review for over two decades. How can the Agencies build the RBA as the core component of the U.S. Proposal, endorsing both rating agency methodology and review, and then disregard this same methodology and review when applied to banks' internal systems? An internal system that is consistent with rating agency methodology is the perfect hybrid of an internal approach and rating agency approach that provides a substantially more reliable and verifiable means of calculating regulatory capital requirements than the proposed SFA. Furthermore, this system which would assign risk weights based on the external rating equivalent of the internal rating will provide consistency between the term markets (where transactions are typically rated) and the markets, particularly the ABCP market, where transactions are not typically rated. An approach that distorts required minimum capital, as we believe the A-IRB would do, will perpetuate the arbitrariness of the current Accord and undermine rational decision making within firms.

As a result, we recommend that banks be permitted to produce their own internal ratings and systems to determine required capital for liquidity and credit enhancement positions supporting ABCP conduit transactions so long as the ratings of a position is at least investment grade. This proposal expands to liquidity commitments the internal approach currently in place in the United States for credit

[6] We note that in some instances, a particular conduit transaction may not fit neatly within a rating agency methodology and look forward to working with you prior to the adoption of the U.S. Proposal in determining a framework for defining rating agency methodology as well as crafting a rule with sufficient flexibility to address the exceptional cases where a particular transaction falls outside the scope of any defined methodology.

enhancement positions where the Agencies have already shown their satisfaction with the ability of ABCP conduit sponsors to analyze positions constituting and supporting the conduit's asset pool using a variety of models and methods of analysis that have proven highly reliable.

Under our proposal, a bank would be permitted to produce their own internal ratings generated from one or more risk assessment models used by recognized external credit assessment institutions or models and methods of analysis employed in an internal system, provided that such bank has received specific approval from its regulator to do so. Approval would be subject to a regulator's complete satisfaction with a bank's ability to apply such models in a reliable manner and the regulator's ability to validate it.

We note that the methodology described is not used for all other types of unrated securitization transactions. If the Agencies were willing to consider an internal approach for other types of transactions, we would be happy to work with you to find workable alternatives to the SFA for these other transactions.

*(C) Credit should be given for funding formula adjustment in liquidity positions*

We believe that the current A-IRB will result in a significant overstatement of required capital for true liquidity positions provided to ABCP conduits. The key reason for this overstatement is the failure of the approach to reflect the protection provided by (i) the often dynamic asset quality tests inherent in these positions coupled with (ii) the presence of significant risk-mitigating protections inherent in the underlying transactions which together provide a conduit sponsor with the ability to actively manage a transaction to reduce the level of exposure by a liquidity bank to the risks in the related portfolio.

We again note the importance of the presence of asset quality tests in liquidity positions. Generally, these tests are used to reduce the purchase price paid (and therefore the exposure) of a liquidity bank when all or a portion of a transaction is put to the liquidity. These tests generally reduce the purchase price dollar-for-dollar to the extent of defaulted receivables once transaction level reserves and overcollateralization have been used (in some cases, this reduction can set in prior to a full erosion at the transaction level).

We understand that there is some concern that these tests are mere window-dressing in that a bank will put a transaction to liquidity well prior to the time that these tests would kick in. We note, however, that conduit securitizations are typically structured to have increased pricing—not only funding through LIBOR but also an increased margin—once a transaction is funded through liquidity. A bank is not going to put performing transactions into liquidity at the hint of a potential

problem—that bank would simply not continue to have credibility with its clients or a viable presence in the market.

Even assuming the worst, it is important to remember that conduit transactions are structured to be managed. There are a number of features in place that allow for a sponsor to manage a transaction to limit exposure as a portfolio or servicer credit deteriorates. These can include performance triggers permitting the acceleration and amortization of a transaction, the ability to replace a servicer, the ability to require daily cash segregation (whether at all times or upon certain triggers) and annual credit reviews that permit termination of a transaction or modifications to address performance issues prior to renewal. These are simply a few of the myriad of features that can be and are built into conduit securitizations with the goal of permitting the active management of these transactions as they begin to deteriorate. Given that banks do not structure these transactions planning that they be funded on their balance sheets, it should be apparent that they will be not only managing a transaction to reduce exposure prior to a liquidity funding, but also to reduce funded exposures as quickly as possible. This high degree of management ability distinguishes conduit transactions from term securitizations. We believe that historical performance supports our position

The utilization history of liquidity commitments (including parallel purchase commitments) of the conduits administered by 17 banks participating in the preparation of this comment supports the argument in favor of a lower conversion factor for liquidity commitments. The conduits administered by these banks issue approximately 80% of all multi-seller conduit ABCP outstanding as of September 30, 2003. The results of the survey conducted by Mayer, Brown, Rowe & Maw are set forth below.

- Conduits for which information was reported have been in operation for periods ranging from 0.5 years to 20 years, with the mean period of operation being 10.4 years.

- These conduits have funded securitization transactions with an aggregate principal balance of $886.9 billion.

- For all transactions, only 148 liquidity draws have been made, for an aggregate amount of $12.1 billion.

- The aggregate amount of drawn commitments represented 1.36% of the aggregate amount of funding for the receivables pools.

- Only $593 million in losses have been experienced on liquidity draws in transactions for which the Commenting Banks act as sponsor of a Multi-Seller Conduit, representing approximately 0.067% of all originations.

- Annualizing the cumulative loss percentage by dividing it by the average operating history of the surveyed conduits results in an annual loss percentage of approximately 0.0064%.

The annualized loss percentage is equivalent to that for a AAA exposure. Thus, although many conduits include transactions on average structured to the so called "A" level, the performance under related liquidity exposures is significantly better.

Given that we do not see an adequate way to address the presence of the structural features of liquidity positions and underlying transactions in any A-IRB approach (RBA, SFA or the internal approach we propose), we suggest that the only way that these risk mitigants can be addressed is through the application of a credit conversion factor for liquidity exposures. We envision two credit conversion factor components. One component would give a credit conversion factor for the presence of a dynamic asset quality test in a liquidity position. The other component would give a credit conversion factor for the presence of the types of structural features that permit a conduit to manage a transaction. This second component permits regulators to prevent a bank from getting credit for structural features in underlying transactions where such features do not exist—e.g., term tranches a conduit purchases in the market.

If, as we understand, the only benefit of having an "eligible liquidity facility" under the U.S. Proposal is to be permitted to temporarily use the Look-Through Approach if Kirb cannot be calculated of a particular transaction, we note that there is little, if any, incentive to qualify as an eligible liquidity facility. Rather than leading the market to the higher standards sought with the eligibility requirements, the U.S. Proposal would lead the market to eliminate restrictions on liquidity draws as there would be no benefit for their inclusion. An appropriate conversion factor, as we propose, provides continued incentive for structuring liquidity positions as very safe, low risk transactions.

(D) *Eligible liquidity facility requirements need to be adjusted*

While we understand the regulatory concern for limiting the relatively lower regulatory capital requirements for liquidity facilities to only those that do not serve a credit enhancement function, we do not believe that the current proposal provides any such incentive. As discussed below, we think that a credit conversion factor is appropriate for liquidity facilities and believe that the currently proposed requirements for "eligible liquidity facilities" present significant practical problems that are not necessary to assure that a facility is a "true" liquidity facility. Current market practice is to have liquidity banks generally fund only non-defaulted assets. We believe that the existence of the asset quality tests that serve to protect against the funding of defaulted assets is the single best method of assuring the risk profile of a liquidity position.

We feel that the requirements in clauses (c) and (e) indirectly address that which is directly addressed by the requirement for an asset quality test set forth in clause (b). As to clause (c), a requirement that there can be no funding once transaction level credit enhancement has been exhausted, could lead to the real possibility of an inability to fund in liquidity during an early amortization event under the underlying transaction, something that at least one rating agency has informed us would render the underlying transaction unratable. Additionally, given that banks are given no benefit for the presence of third party provided program credit enhancement, it strikes us as inappropriate to require the shut-down of a liquidity facility when that enhancement is exhausted. A test on the underlying "pool" as described in clause (e), without regard to credit enhancement, is even more meaningless as many securitization transactions begin with pools of unrated or non-investment grade assets that are structured to investment grade risk through the inclusion of credit enhancement, including, without limitation, overcollateralization, and recourse. Furthermore, such a test is unnecessary—as the risk of a position increases more capital will be required to be held against related exposures. Under either circumstance, the asset quality test will serve to protect liquidity by only funding against the performing assets in a potentially deteriorating pool and we ask that the Agencies look solely to existence of the asset quality test for eligible facilities to address the concerns currently covered by clauses (b), (c) and (e).

We are concerned that an independent "fair value" test will be difficult as a practical matter to apply and unacceptable to rating agencies. We believe that the "fair value" requirement should be satisfied through the presence of a funding formula that prohibits funding against defaulted assets as required by clause (b). If the Agencies feel that some test in addition to the asset quality test is necessary, we would be happy to work with you in developing an appropriate standard to address your concerns.

We also believe that clause (d) should clarify that the liquidity is not subordinate to other investor interests at the same ratings level. We feel this change is necessary to clarify that the payment of servicing fees and other fees typically at the top of a transaction level waterfall would not make a liquidity facility ineligible. We note that the conduit, whether funded in liquidity or by ABCP would be paid at the same level in a transaction level waterfall and that the risk profile to a conduit remains the same. The effect of being subordinated to these senior fees are fully accounted for in the risk of the underlying position.

We believe that a prohibition against a liquidity facility providing credit enhancement, without further identifying or limiting the circumstances under which a facility may be drawn, as contemplated by clause (a), should be sufficient to maintain the integrity of true liquidity positions. Currently, rating agencies are very reluctant to see any limitations, other than an asset quality test and certain bankruptcy issues related to a conduit, on the ability of a bank to draw under liquidity. We are

concerned about the practicality of proscribing a comprehensive list of circumstances under which a facility could be drawn which would address all scenarios unrelated to draws for credit enhancement purposes. We believe that the prohibition against funding for credit enhancement, along with the other requirements for eligible liquidity facilities as discussed above provide a practical approach to preserving the integrity of liquidity commitments.

We also believe that the appropriate asset quality test for some securitizations is a ratings trigger (i.e. no funding when the rating of a transaction or guarantor falls below a specified level) when it is the public rating of an underlying transaction or a guarantor that is relied upon by the applicable liquidity provider(s) rather than the underlying pool performance. In these circumstances, rather than a requirement that the facility not fund against defaulted assets, the appropriate threshold should be that they not fund when the relied upon rating falls below BB, given that the average rating of corporate loans held by United States banks is in the area of BB.

Finally, we believe that the U.S. Proposal should make clear that liquidity facilities that are not "eligible" should be treated as any other securitization position. A required deduction from capital, as suggested in the Accord but left unclear in the U.S. Proposal, would be overly punitive.

*(E) Treatment of unrated liquidity facilities under the A-IRB*

Under the A-IRB if a liquidity position is not rated, we believe that a bank should have the option to look-through to the risk weight assigned to the underlying tranche that the liquidity supports if that underlying transaction has been externally rated, whether publicly or privately by one eligible rating agency (or, if our internal approach is adopted, the rating applicable using this approach). Given that the underlying tranche reflects the ultimate risk of a liquidity position, we see no reason not to permit the reliance on that rating if a liquidity position itself is not rated. We propose the U.S. Proposal allow regulators the flexibility to maintain a list of "eligible" rating agencies that are well established, of sufficiently high caliber, and have demonstrated expertise in securitization to warrant recognition of their private letter ratings in this context.

We note that when looking to the underlying rating of a tranche (whether public, private or derived under our internal approach), we believe that the short term equivalent of that rating is the appropriate proxy for determining the risk weight for a related liquidity position that is for one year or less. Because of the short-term nature of the risk to a bank under a one year commitment, were a bank to have a rating assigned to a liquidity position directly, it would appropriately request a short-term rating to be assigned to such a position.

While we believe that such a look-through approach might still result in capital greater than that necessitated by the risk of a liquidity position, in that it does not give

credit for the structural protection provided by a dynamic asset quality test in the liquidity position itself, we feel that it is a viable alternative that should be available to banks to avoid the burdens of the application of the SFA approach and the resulting negative impact on the multi-seller conduit ABCP market while still providing regulators with reassurance that a rating agency has reviewed the underlying risk exposure of a position.

4. **Cap at Kirb should apply for originators**

We support the currently contemplated cap on required capital for retained positions of an originator at the Kirb of the underlying pool as if it had not been securitized. Assuming that the Kirb of the underlying exposures is appropriately calibrated, it is inappropriate to hold more capital for a part of that risk as opposed to the entirety of that risk. Without the cap, total capitalization after a securitization could be multiples of capital prior to a securitization, a result that further evidences the miscalibration of the RBA and SFA for securitizations. We further continue to advocate the ability to use assigned ratings to override positions within Kirb that have true credit protection, either through the tranching of the Kirb exposure or through the presence of credit risk mitigants not recognized in the SFA. We do not believe that the presence of one of these features should preclude the presence of the other. They address separate issues that should be separately considered on their merits.

5. **Synthetics should not be discriminated against vs. cash transactions**

The U.S. Proposal imposes calibration distortions on synthetic securitizations over and above those imposed on cash securitizations. Conceptually there should be no discrepancy between the capital relief provided under a synthetic structure versus a cash securitization to the extent the risks retained or transferred are comparable.

Currently the proposals for the risk weighting for super senior tranches do not reflect the superior quality of such tranches as compared with senior tranches below the super senior tranches. Commercially the market and investors acknowledge that super senior tranches are those tranches that rank above the highest rated tranche and thus are priced accordingly, yet the proposals appear to distort commercial reality by imposing a regulatory cost on such tranches that is excessive when compared to actual risk. This in turn discriminates against synthetic transactions by making them inefficient when compared to cash transactions.

In a joint letter from the European Securitisation Forum and the International Swaps and Derivatives Associations, Inc., delivered to the Basel Committee on Banking Supervision in March 2002, data was provided that compared the amount of capital relief achieved by using synthetic and cash securitizations on generic portfolios of 'A2' and 'Baa2' corporate bond/loans, as well as residential mortgages. If substitution applies, a synthetic transaction involving corporate bonds under the Standardised Approach of the Accord only releases between 41% and 73% of the

amount of capital released in a cash transaction involving the same assets, reflecting the additional capital charge (1.47% and 1.40% respectively) applied on the super-senior position. We believe that a comparable conclusion would be reached if this comparison were to be made under the A-IRB approach.

Finally, the substitution approach to credit risk mitigation gives rise to significant discrepancy between the regulatory capital cost of hedges and their internal cost, causing distortion of pricing and risk management, and depriving regulated entities of business opportunities that will instead go to their non-regulated competitors. By merely substituting the risk weighting of a guarantor or credit protection provider for that of the underlying assets, the proposals overstate the double default probability and understate the protection provided by the hedge acquired on the super senior tranche. This unduly conservative correlation assumption is economically unrealistic and produces onerous results. A more risk-sensitive capital treatment can be found in the previous proposals of the International Swaps and Derivatives Association, Inc., on the Accord We note that these issues and an alternative proposal have also set forth in the recently released paper on this topic from the staff of the Federal Reserve Board[7]. We note this comment applies equally to traditional cash transactions, as well as synthetic transactions.

6. **Credit for first loss positions being established for compliance with new consolidation rules**

The Financial Accounting Standards Board (FASB) in the United States recently adopted an interpretation of its accounting rules that requires a conduit to be consolidated with the holder of the majority of the expected losses of the conduit.[8] In order to not consolidate a conduit, many banks are in the process of restructuring their conduits by selling to third party investors positions which are truly structured to absorb a majority of the first loss risk of the conduit.

Under the U.S. Proposal, there is no means of reflecting the benefits to a conduit of the presence of this real first loss protection. We believe that a mechanic should be in place to provide dollar-for-dollar credit to the extent that a bank's independent auditor's have satisfied themselves that a third party holds the true first loss risk of the conduit and does not require a sponsor bank to consolidate the assets and liabilities of the conduit.

7. **Additional Comments**

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[7] "Treatment of Double-Default and Double-Recovery Effects for Hedged Exposures under Pillar I of the Proposed New Basel Capital Accord—A White Paper by the staff of the Board of Governors of the Federal Reserve System in support of the forthcoming Advance Notice of Proposed Rulemaking" June 2003.

[8] FASB Interpretation No. 46, Consolidation of Variable Interest Entities.

In addition, to our key points set out above, we have also set out additional technical comments on various aspects of the U.S. Proposal in Appendix B to this letter.

## 8. Conclusion

While we continue to support the Agencies' efforts to reform regulatory capital requirements, we remain quite concerned that there are a number of problems in the current proposal that lead to inappropriate capital requirements for securitization positions. Although we understand the desire for finalization of the revised Accord and implementation within the United States within a relatively short time frame, we believe that there needs to be extensive further analysis of the underlying assumptions and data relating to securitizations prior to the finalization of either the Accord or the U.S. Proposal. We strongly feel that this further analysis will result in significant changes to the U.S. Proposal to more appropriately calibrate the regulatory capital requirements.

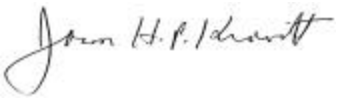
* * * *

We appreciate this opportunity to comment on the U.S. Proposal. We look forward to continuing to work with the Agencies and their staff as we move closer towards the adoption of the revised Accord in the United States.

Vernon H.C. Wright
*Chairman, American Securitization Forum*
*(MBNA America Bank)*

Greg Medcraft
*Deputy Chairman,*
*American Securitization Forum*
*(Société Générale Securities Corp.)*

Dwight Jenkins
*Executive Director*
*American Securitization Forum*

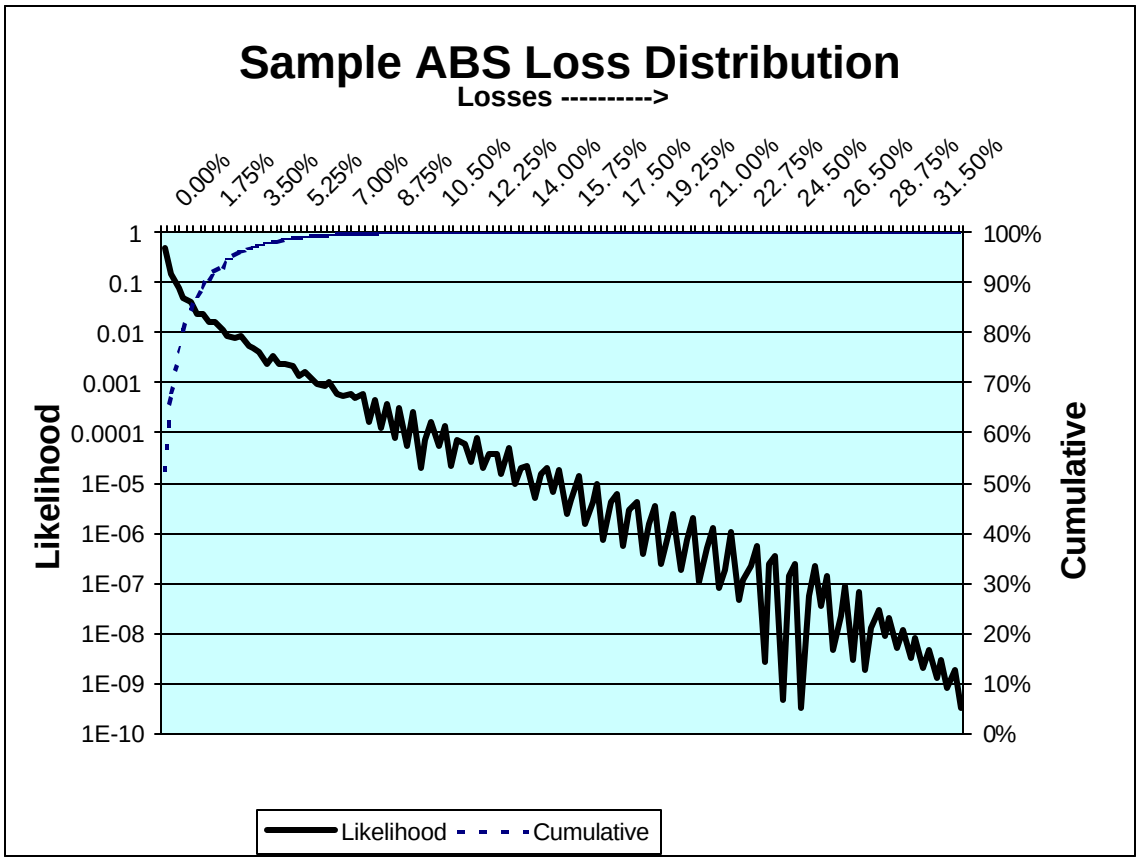


Jason H.P. Kravitt
*Secretary, American Securitization Forum*
*(Mayer, Brown, Rowe & Maw LLP)*

APPENDIX A

## 1. ACTUAL LOSS DISTRIBUTION FOR US AUTO LOAN TRANSACTION

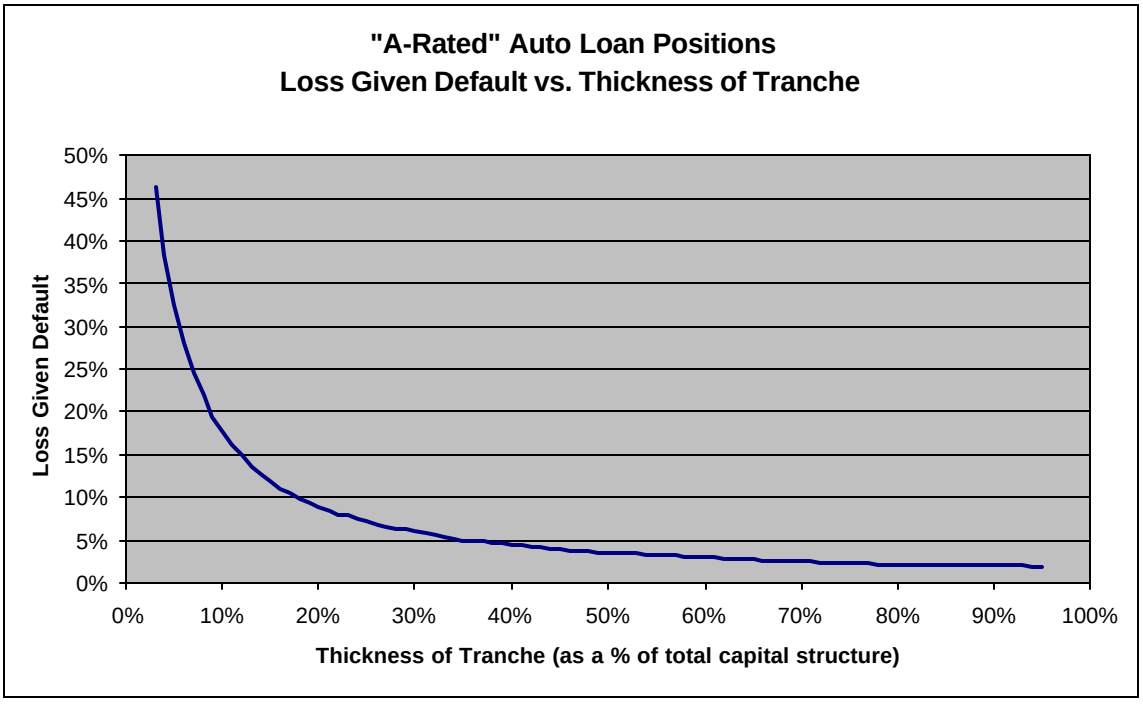
This graph depicts the modeled loss distribution of a representative US auto loan pool. Noting the log scale on the likelihood axis, the likelihood of losses can be seen to drop off dramatically as the losses become larger.



## 2. RELATIONSHIP BETWEEN LGD AND TRANCHE THICKNESS FOR ACTUAL US AUTO LOAN TRANSACTION

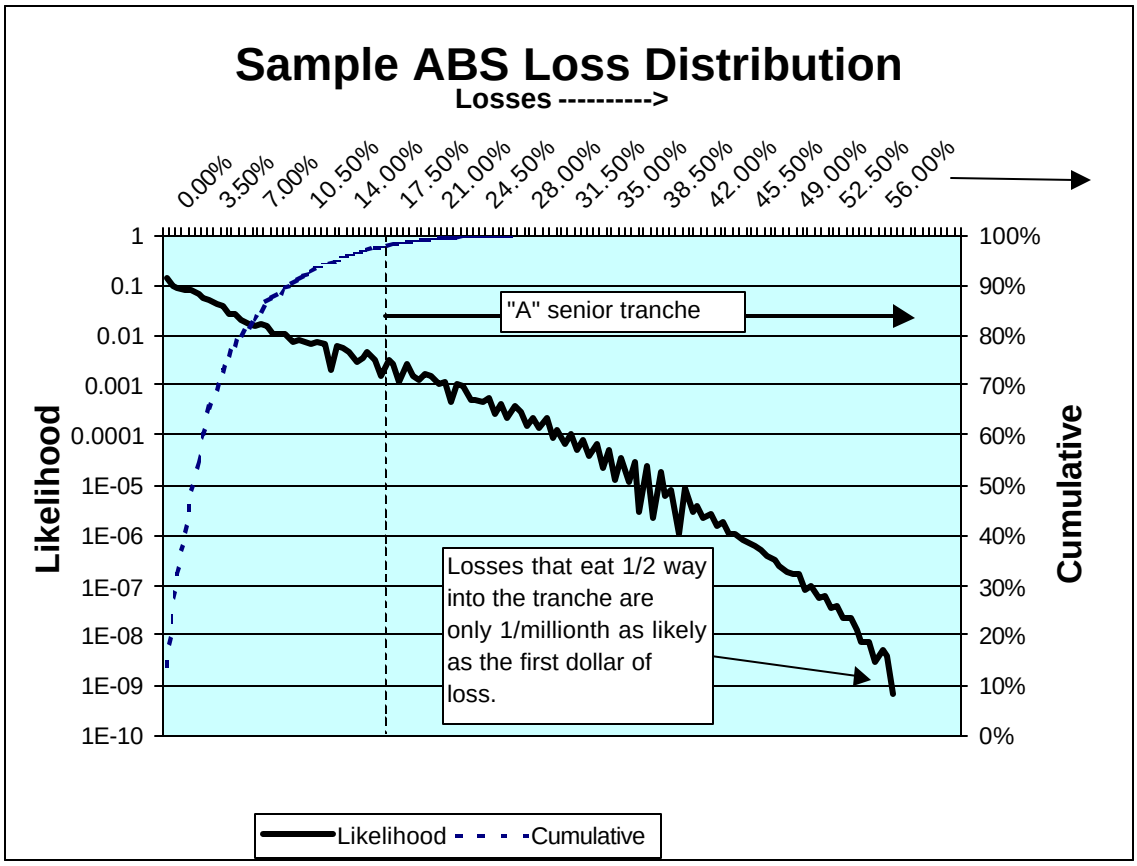
This graph is based on the same data as the previous graph and depicts the loss given default (LGD) of an "A"-rated tranche created from that portfolio using a "PD" based methodology. This methodology simply specifies that the amount of enhancement should be a given multiple of expected loss. The amount of enhancement in this case was 5%.

Note that the LGD for a thin tranche is some 20 times higher than for a senior (and therefore very thick) tranche. Assuming a 50% LGD for a given PD is only valid for very thin tranches.



## 3. ACTUAL LOSS DISTRIBUTION FOR US HOME EQUITY TRANSACTION

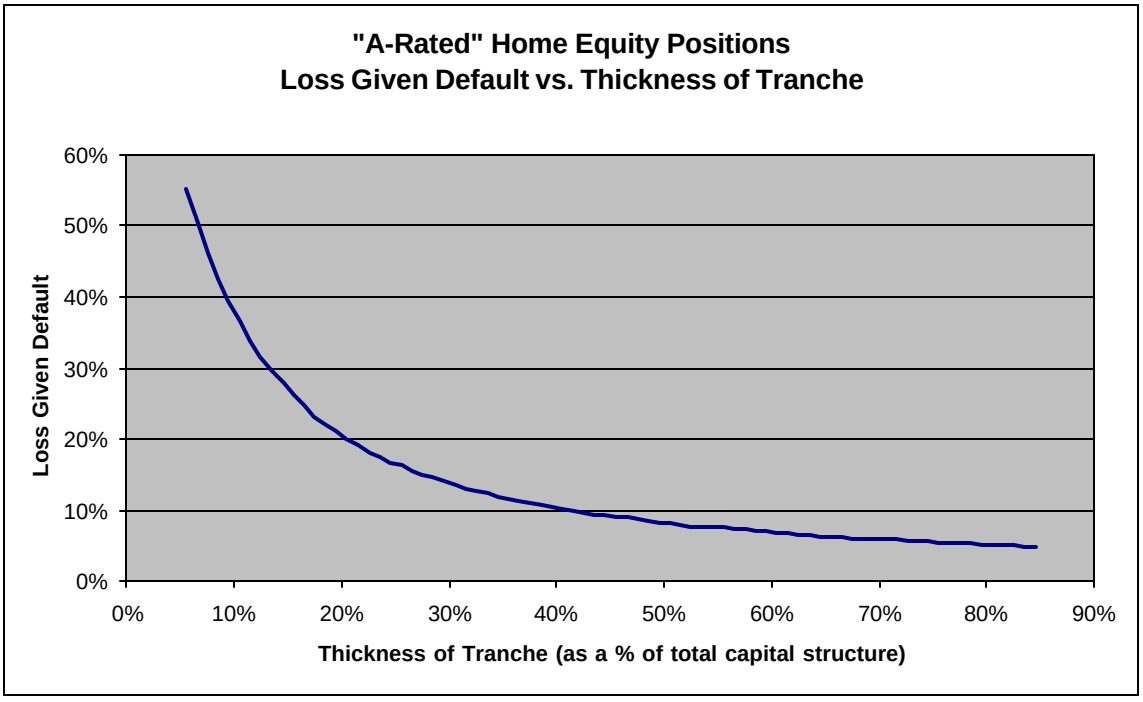
**This graph depicts the modeled loss distribution of a representative US home equity pool. As in the previous graph, we can see that the likelihood of losses can be seen to drop off dramatically as the losses become larger. In fact, losses that comprise 50% of a thick tranche are only 1/millionth as likely as small LGD's.**



**Relationship between LGD and Tranche Thickness for Actual US Home Equity Transaction**

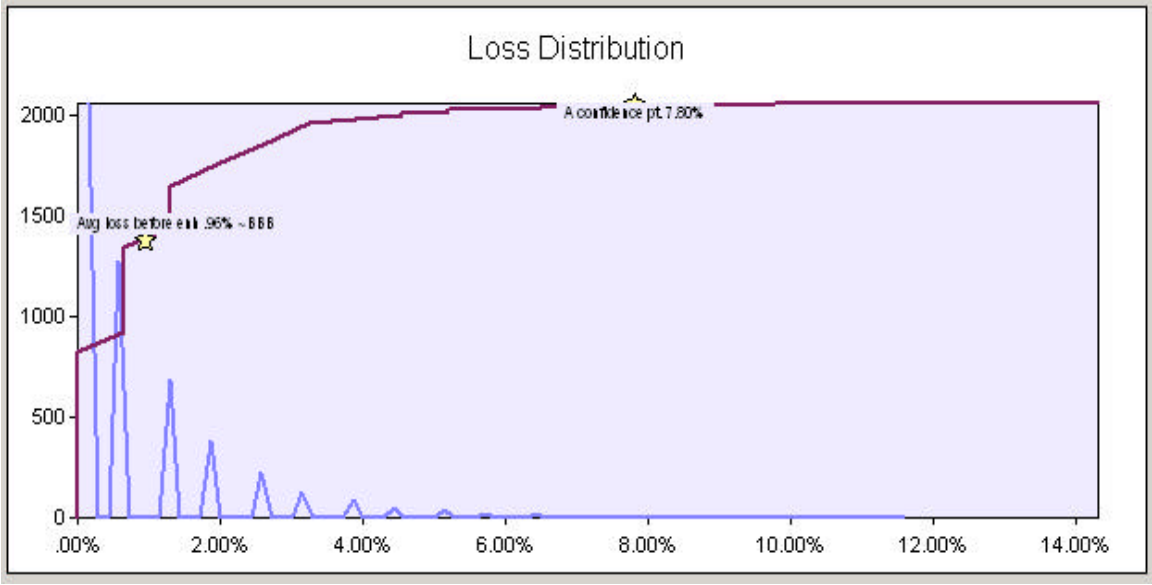
As in the previous set of graphs, this depicts the loss given default (LGD) of an "A"-rated tranche created from the home equity portfolio using a "PD" based methodology. Again, this methodology specifies that the amount of enhancement should be a given multiple of expected loss. The amount of enhancement in this case was 15.5%, as the expected losses in the underlying pool are substantially greater (4.2% vs. 0.7% for the auto pool).

Note that the LGD for a thin tranche is some 10 times higher than for a senior (and therefore very thick) tranche. Assuming a 50% LGD for a given PD is only valid for very thin tranches.



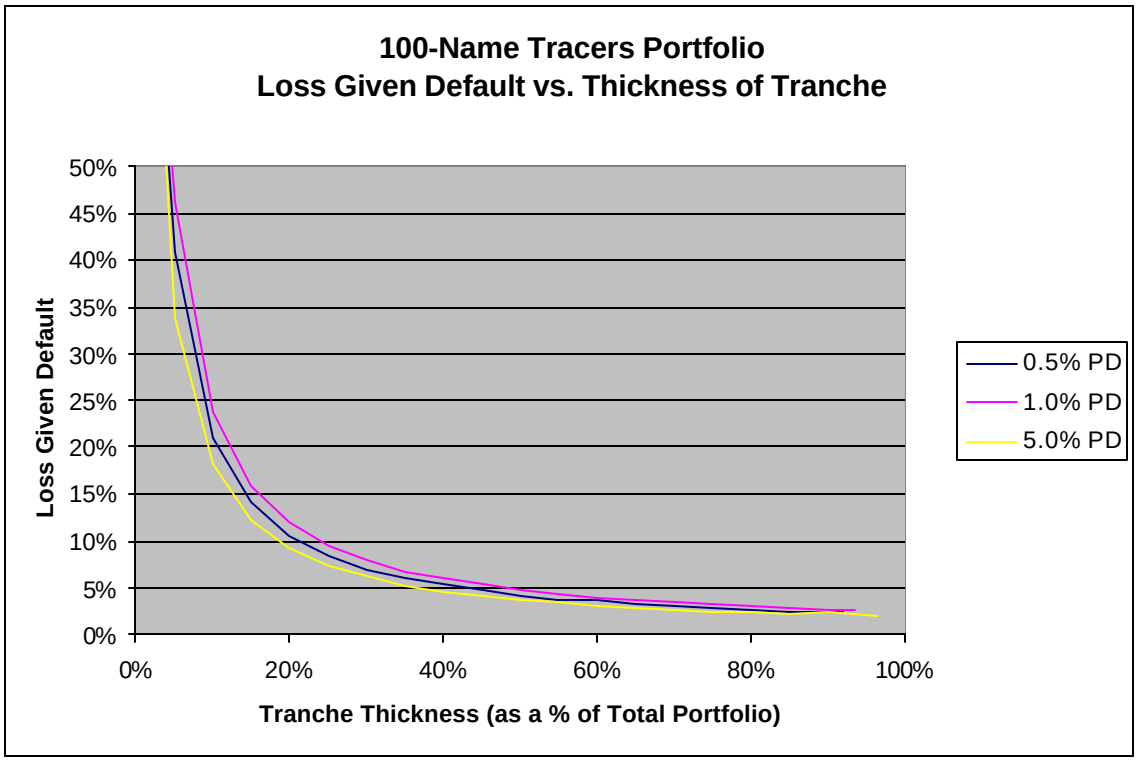
**Actual Projected Loss Distribution for 100-Name Corporate Portfolio (Morgan Stanley Tracers Portfolio)**

**The following graph depicts the loss distribution for a 100-name corporate portfolio, the industry standard 100-name Tracers portfolio created by Morgan Stanley. As before, we can show that tranches created from this portfolio using a PD-based approach would have the same general characteristics as the retail pools. Thick tranches would have a small fraction of the LGD of thin tranches.**



**Relationship between LGD and Tranche Thickness for Actual 100-Name Corporate Portfolio (Morgan Stanley Tracers Portfolio)**

**For this analysis, we created three different tranches with PD's of 0.5%, 1.0% and 5.0%. Interestingly, the LGD's for these tranches are related only to their thickness and not to their PD. Again, the thin tranches show 20 times the LGD of the thick senior tranches.**



## Appendix B

Additional Comments

A. *Conduit Sponsors as Originators*

We continue to feel that it is inappropriate to treat conduit sponsors, liquidity and credit enhancement providers (collectively, "sponsor entities") as originators in many instances. The references we object to are set forth below—note that where the U.S. Proposal only cross-references the Accord, we reference the applicable Accord provisions:

--Paragraphs 508 and 518 of the Accord, relating to clean-up calls at the discretion of the originating bank. This reference should be solely to the true originator as sponsor entities are irrelevant here.

--Paragraph 514 of the Accord, defining an SPE as being set up isolated from the credit risk of the originator. The sponsor entities are irrelevant to this analysis.

--Paragraph 516 of the Accord, setting forth operational requirements for traditional securitizations. This analysis is looking solely to the relationship between an SPE and the true originator.

-- Paragraph 517 of the Accord, setting forth operational requirements for synthetic securitizations. This analysis is looking solely to the relationship between an SPE and the true originator.

--Pages 75-77 of the U.S. Proposal, discussing capital treatment for positions retained by originators and others. We don't believe the inclusion of sponsor entities is appropriate—their capital treatment is separately covered.

--Pages 88-90 of the U.S. Proposal, setting forth the required capital relating to transactions with amortization features. This should apply only to true originators as sponsor entities do not share the same risk profile.

B. *Commercial Paper Dealers/Placement Agents as Originators*

We believe that it is inappropriate in any case to treat dealers and placement agents of ABCP as originators under the U.S. Proposal if these entities do not provide liquidity or credit enhancement and hold no other position in a conduit transaction. These entities simply do not have any credit risk or specific knowledge of transactions being securitized and should not be submitted to a regulatory regime that assumes, by defining them as originators, that they do.

C. *Risk Weights Assigned for Unrated Liquidity Positions under Look-Through Approach*

Under the proposed Look-Through Approach, the risk weight applicable to unrated liquidity positions is the highest risk weight assigned to any of the underlying exposures covered by that position. We believe that the more appropriate measure is to look to the weighted average of the risk weights. This weighted average risk would reflect the true risks in the portfolio as opposed to an overly conservative estimation of the risks reflected by an assumption that the highest risk asset (regardless of size) is a valid estimate for the risk in the entire portfolio.

D. *Use of "Inferred Ratings" for Securitizations*

We believe that the required use of an "inferred" rating based on a subordinated tranche should not be required for any securitization position. Such a requirement forces a bank to hold incrementally more capital for a senior position than that warranted by its risk. A well-developed internal bank approach or, if not permitted, SFA should provide a sufficient means of determining the appropriate required capital.

If the Agencies were to reject this proposal, we request that the Agencies confirm that payment of current interest to holders of a rated subordinated position (absent default) will not jeopardize a bank's ability to infer a rating for the senior position on the ground that such a provision would render the rated position as not being "subordinate in all respects" to the unrated position.

E. *Operation Requirement for Control of Cash Remittances*

The requirement that "under all foreseeable circumstances the bank have effective ownership and control of the cash remittances from the receivables"[9] should be adjusted in several respects. First, this "legal certainty" test should be no more strict than that required currently by rating agencies. Second, the Agencies should drop the requirement of ownership of the cash remittances, relying instead on control. In many cases, the conduit does not acquire ownership of the receivables themselves, but rather an undivided interest in the receivables. Moreover, until certain negotiated trigger events specified in the contracts occur, cash remittances are commonly co-mingled by the originator, acting as servicer (after those events occur, the conduit has the right to take control over the cash remittances), and the top-down rules should permit such practices to continue. Third, liquidity is often provided to the conduit as a loan, and the liquidity provider is not a purchaser of the receivables and accordingly is not their owner.

In short, it should be acceptable that the conduit has acquired the receivables or an interest therein, and that a servicer collects and distributes the remittances pursuant to a servicing agreement (with the right of the conduit to take control over such remittances after specified trigger events occur). Because the conduit will be structured as a bankruptcy remote entity and its interest in the receivables and remittances will have been the subject of customary legal opinions regarding the enforceability of the contracts, there should be no requirement

9 Paragraph 457 of the Accord, which is cross-referenced in the U.S. Proposal.

that the conduit actually own the receivables or that the liquidity facility providers own the receivables, be secured by them or participate in their collection before the trigger events have occurred. The Agencies should also clarify that "effective control" can be established by delivery of customary legal opinions regarding the enforceability of the relevant documents with customary assumptions and qualifications.

F. *Early Amortization Capital Requirements*

We support the Agencies' proposal recognizing early amortization risks and their associated capital requirements will vary based on both the asset type and the nature of the early amortization provisions. Nevertheless, there are a number of needed changes to the qualification conditions for controlled early amortization treatment. First, the U.S. Proposal should be clear that the amortization requirements would apply only to economic pay-out events and not normal amortization or accumulation periods. The early amortization capital charge represents a new capital requirement specifically targeting the credit and liquidity risks associated with early amortization events – when things go bad. As a result, the amortization requirements should only apply to the specific economic early amortization risk. During normal amortization periods, the loans, by definition, are performing well and liquidity requirements are incorporated into the bank's liquidity planning process.

Second, we believe that the requirements for when an amortization provision is considered "controlled" are too restrictive by requiring that there be a pro rata sharing of interest, principal, expenses, losses and recoveries based on the balance of receivables outstanding at the beginning of the month. We believe the two other requirements set forth for "controlled" amortization provisions clearly establish the fundamental principles for these amortization. Namely, they state that 1) the amortization period be sufficiently long so that 90% of the debt outstanding at the beginning of the amortization period is repaid or recognized as in default and 2) amortization occurs at a pace no more rapid than straight-line amortization. We believe that the U.S. Proposal should clearly articulate a guiding principle as it has done with the two provisions referred to in the preceding sentence, and not micro-manage the rules. Therefore, we believe the pro rata sharing requirement should be deleted in its entirety.

Third, we note that while the proposed amortization rules make sense in the credit card context, it is not clear that the same application should be used across the board for other revolving retail assets. For example, some securitizations early amortization provisions are linked to the size of the overcollateralization in a transaction. Therefore, the appropriate triggers in those securitizations should be to the level of overcollateralization rather than the level of excess spread. The final rules for amortization provisions should provide regulators with sufficient flexibility to apply appropriate modifications to the amortization rules when the context requires.

Fourth, we would also recommend a simplification of the early amortization capital requirement that would make implementation much easier. The CCF methodology should use the lesser of 4%, or the point at which the organization would be required to begin

trapping excess spread as the starting reference point. This would allow for broad consistency across the industry, with four, simple 1% quadrants. This would also help the test be more operational for originators and verifiable for examiners. Slight variances in the starting point for trapping excess spread are not uncommon and not necessarily indicative of significant risk differentiation in the underlying assets. You will find that originators may have different spread triggers for transactions from the same asset pool. A standard starting reference point will make it much easier for originators to implement without sacrificing much from a risk perspective. In fact, KIRB actually captures the risk of the underlying assets and is already a component of the methodology. We also believe it is important to allow flexibility for non-credit card asset types to have excess spread start points less than 4% if they can be justified.

Finally, we recommend a reduction to the CCFs for non-controlled early amortization risk. The following conservative CCFs for non-controlled early amortization structures: 0%, 2%, 4%, 40%, and 80% or twice as large as the factors used for controlled early amortization would represent a more appropriate risk differential.

G. *Flexibility for Exercise of Clean-Up Calls*

Banks should be permitted to exercise a clean-up call when the securitization exposures fall below 10% of either (i) the original principal amount of exposures issued or (ii) the original pool balance of all assets acquired to support such exposures. The purpose of the clean-up call is administrative convenience when the size of a transaction no longer justifies the servicing costs. We believe that, if appropriately exercised so as to not be implicit support, whether the 10% is based on the size of the pool or the size of the remaining balance of exposures should be irrelevant. We note that many clean-up calls are currently based on the size of the issued exposures and would have to be unnecessarily amended (which can be time consuming and costly in the term market) if our comment were not taken.

H. *Treatment of Credit Risk Mitigants*

The treatment of maturity mismatch set forth in the U.S. Proposal is very conservative and will create a significant commercial disincentive for Banks to manage credit risk using portfolio credit default swaps, which are the primary tool used in synthetic securitization transactions.

Where the term of an underlying exposure exceeds the term of a credit hedge, there result is a potential forward credit exposure. Though there is no actual credit risk in relation to this forward exposure, capital is still required to be held - presumably to mitigate against the ADI having to raise additional capital in the future.

However, these are only potential forward exposures, as the underlying assets may be prepayable such that the expected life of the asset differs from the contractual life. For example, a pool of housing loans with a 30 year contractual term may have an expected life of around 4 years. If an ADI only sought to hedge the commercial risk of an asset (the

expected life), in this scenario the ADI would initially still have to hold 26/30 (86%) of the credit risk capital against the potential forward exposure.

An ADI's ability to raise capital in the future should be considered in the context of its overall capital management strategy – overall balance sheet growth, size of potential forward exposures relative to the overall capital base, the expected forward exposure taking into consideration the prepayment rate on the underlying assets.

The maturity mismatch rules are designed to mitigate against an ADI having to raise capital in the future but are a clumsy tool – since it does not take into consideration an ADI's capital position. As a result, a regional bank seeking to sell down concentration risk to prepayable assets may find it uncommercial to do so, notwithstanding that the potential forward exposures would represent a very small percentage of its overall capital base. By creating a commercial disincentive to carry out portfolio credit default swaps, the risk of having to raise capital in the future becomes more important than the credit risk already on the balance sheet which the institution wants to manage prudently.

Suggested alternatives:

- Retain the requirement to give no recognition for maturity mismatch with less than 12 months to expire, but provide relief for mismatches >1 year subject to approval & monitoring by local regulator of the size of potential forward exposures in context of overall capital management strategy of an ADI; or

- Introduce credit conversion factors for maturity mismatch which reflect the likelihood that an ADI can raise capital (or enter into new credit hedges) in the future as necessary to support the potential forward exposure. Credit conversion factors would reduce as the time to crystallization of the potential forward exposure increases (i.e. 100% for less than 1 year, 20% for less than 2 years, 0% for greater than 2 years)

- Retain the existing conservative framework but utilize the expected life of an asset rather than its contractual maturity for the purposes of determining whether any maturity mismatch exists.

I. *Limitation on Deduction from Capital for Credit Enhancing Interest Only Positions*

We believe that there should be a deduction from capital for credit-enhancing interest only positions to the extent such positions exceed 25% of Tier 1 capital as currently in effect in the United States. Such a limitation would appropriately address volatility concerns while not overly penalizing originators who retain credit enhancing interest only positions as part of an overall portfolio of Tier 1 capital assets.

J. *Treatment of Senior Most Tranches under the RBA*

In addition to the recalibration of risk weights in column 1 of the RBA Risk Weight Table discussed in paragraph 1 above, we believe that the senior most tranche of any securitization transaction should be permitted to qualify for column 1 risk weights. These senior tranches

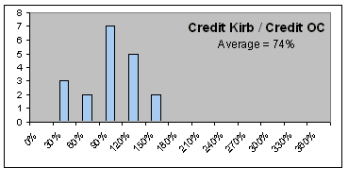
exhibit the relative thickness that merits the lower LGD assumption of this column. We propose that that standard replace the cumbersome and often unworkable "Q" measurement test. If this were not acceptable for all senior most tranches, we believe that thick tranches rated "A/A2" should qualify for such treatment.

K. *Use of an Alternate RBA Approach*

We do not believe that an Alternate RBA Approach is appropriate for those asset classes for which an A-IRB Approach is unavailable to a bank. So long as a position has been rated, the bank should be permitted to use the RBA Approach regardless of whether it is an originator or an investor. We anticipate that it will be the exception rather than the rule that an A-IRB Approach will be unavailable to a bank for a particular asset class for the banks expected to be covered by the A-IRB in the U.S. In these limited circumstances, we believe that regulatory review and monitoring of the development of a particular A-IRB is more appropriate than requiring potentially distortive capital treatment for a position.

## Appendix C

Additional Comments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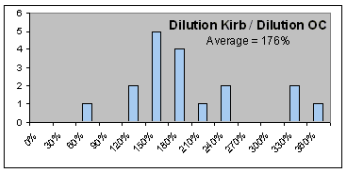
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