

**Meeting Between Federal Reserve Board Staff
and Representatives of the American Securitization Forum
January 9, 2012**

Participants: Mary Aiken, David Emmel and April Snyder (Federal Reserve Board)

Scott Stengel and other representatives of the American Securitization Forum

Summary: Staff of the Federal Reserve Board met with Scott Stengel and talked by phone with representatives of the American Securitization Forum to discuss implementation of the Basel III liquidity standards in the United States, including with respect to commitments and how these standards may interact with implementation of the Basel III capital standards. A copy of the handout provided by the representatives is attached.



OPTIMIZING THE LIQUIDITY COVERAGE RATIO

*WITH A FOCUS ON
ASSET-BACKED COMMERCIAL-PAPER FACILITIES*

JANUARY 9, 2012

Targeted adjustments to Basel III, which enhance rather than diminish the framework, would prevent the LCR from unnecessarily harming customers that rely on ABCP and other securitization facilities.

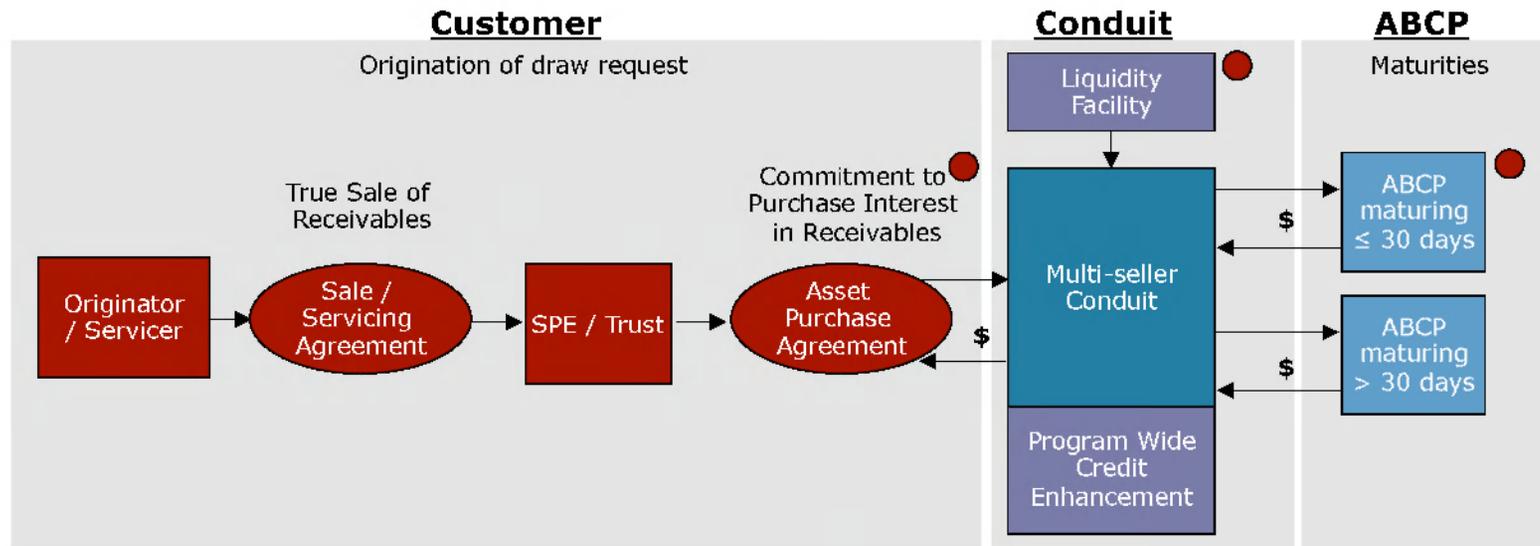
Basel III	Findings from ASF Analyses (with a Focus on the Period between 2005 and 2010)	Targeted Adjustment to Basel III
Paragraph 97 of the Liquidity Standard: in the LCR, 100% draw-downs on the undrawn portions of committed credit and liquidity facilities to any special purpose vehicle (irrespective of its sponsor)	<p>Aggregate monthly change in customer usage, as a percentage of total commitments, never exceeded 3.84%.</p> <p>Aggregate monthly change in cash outflows from banks sponsoring ABCP conduits, as a percentage of total commitments, never exceeded 3.44%.</p> <p>Dividing these by the average unused percentage of total commitments in the data set (31.32%) yields draw-downs of 12.26% and 10.98% respectively at the worst of the crises.</p>	In the LCR, 15% draw-downs on the undrawn portions of the borrowing bases in committed credit and liquidity facilities for securitization transactions
Paragraph 162 of the Capital Standard: in the leverage ratio, inclusion of commitments (including liquidity facilities)	Duplicative capital results from the interaction of the leverage ratio and the LCR. Each US\$1 commitment requires (1) capital under the leverage ratio on the US\$1 commitment, (2) $\geq 100\%$ of the US\$1 commitment in unencumbered Level 1 or Level 2 assets, and (3) capital under the leverage ratio on the $\geq US\$1$ of Level 1 or Level 2 assets.	In the leverage ratio, exclude commitments (including liquidity facilities)
Others: (1) composition of Level 1 and Level 2 assets in the LCR and (2) nth-order effects of the Net Stable Funding Ratio	ASF has commenced a study (1) to gauge the systemic and institutional risks arising from the existing composition of Level 1 and Level 2 assets and (2) to determine whether these risks can be reduced by altering that composition. ASF also has begun to assess potentially adverse nth-order effects of the NSFR's interaction with the LCR.	Proposals to come in the near term

TARGETED ADJUSTMENTS TO THE BASEL III FRAMEWORK

- 1. IN THE LCR, 15% DRAW-DOWNS ON THE UNDRAWN PORTIONS OF THE BORROWING BASES IN COMMITTED CREDIT AND LIQUIDITY FACILITIES FOR SECURITIZATION TRANSACTIONS**
- 2. IN THE LEVERAGE RATIO, EXCLUDE COMMITMENTS (INCLUDING LIQUIDITY FACILITIES)**
- 3. PROPOSALS TO COME IN THE NEAR TERM ON (A) ENHANCING THE COMPOSITION OF LEVEL 1 AND LEVEL 2 ASSETS IN THE LCR AND (B) MITIGATING POTENTIALLY ADVERSE NTH-ORDER EFFECTS OF THE NSFR**

The LCR is expected to adversely affect the pricing and availability of credit for customers that procure working capital from bank-sponsored ABCP conduits.

The ABCP market continues to supply approximately US\$400 billion in funding to businesses and governments around the world.



- The LCR's capital charge for potential cash outflows – which implicates (1) the ABCP conduit's commitments to customers, (2) the bank's liquidity facility for the ABCP conduit, and (3) the ABCP maturing within 30 days – *incentivizes banks to scale back and increase the cost to customers for all unfunded commitments.*

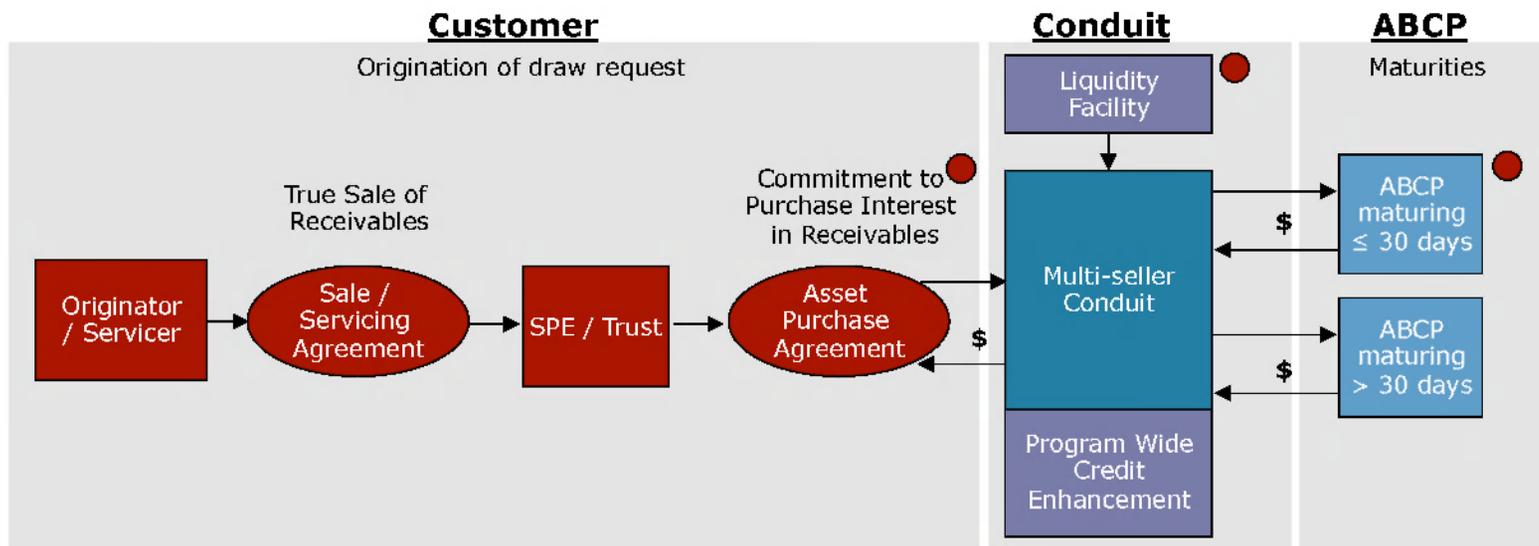
$$\frac{\text{Stock of Unencumbered, High-Quality Liquid Assets}}{\text{Total Net Cash Outflows During the Next 30 Calendar Days}} \geq 100\%$$

The risk of a surge in draws from customers under committed ABCP and other securitization facilities is more limited than the risk associated with general credit and liquidity facilities.

Even during periods of significant liquidity stress or economic shock, draws by customers under committed credit and liquidity facilities in securitization transactions are limited –

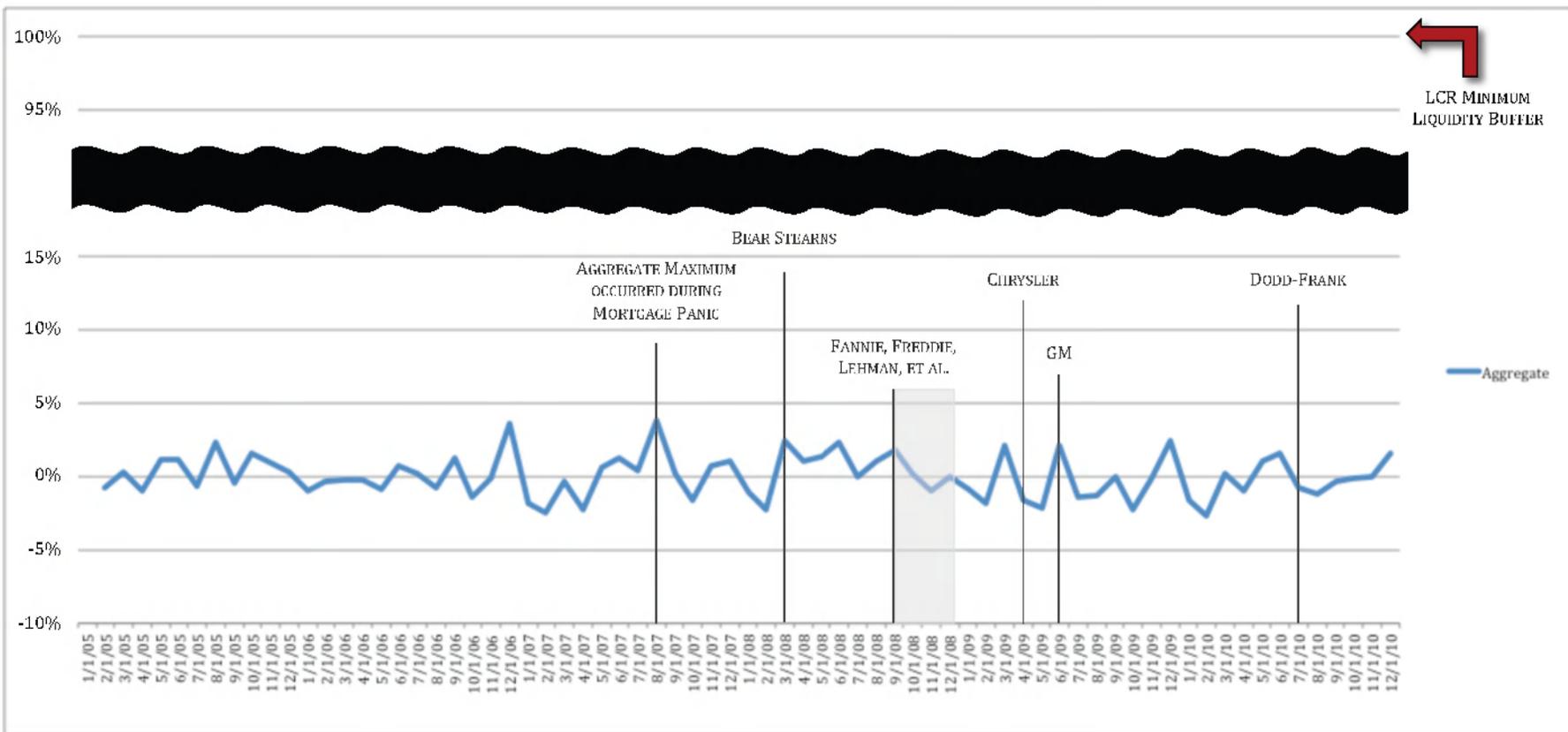
- by the pool of eligible (performing and otherwise unencumbered) receivables and other assets owned by the special purpose vehicle, and
- by the working capital needs of the customer that is sponsoring the special purpose vehicle.

Put another way, only customers that are successfully generating loans and other receivables during the stress scenario would qualify for draws under the securitization facility.



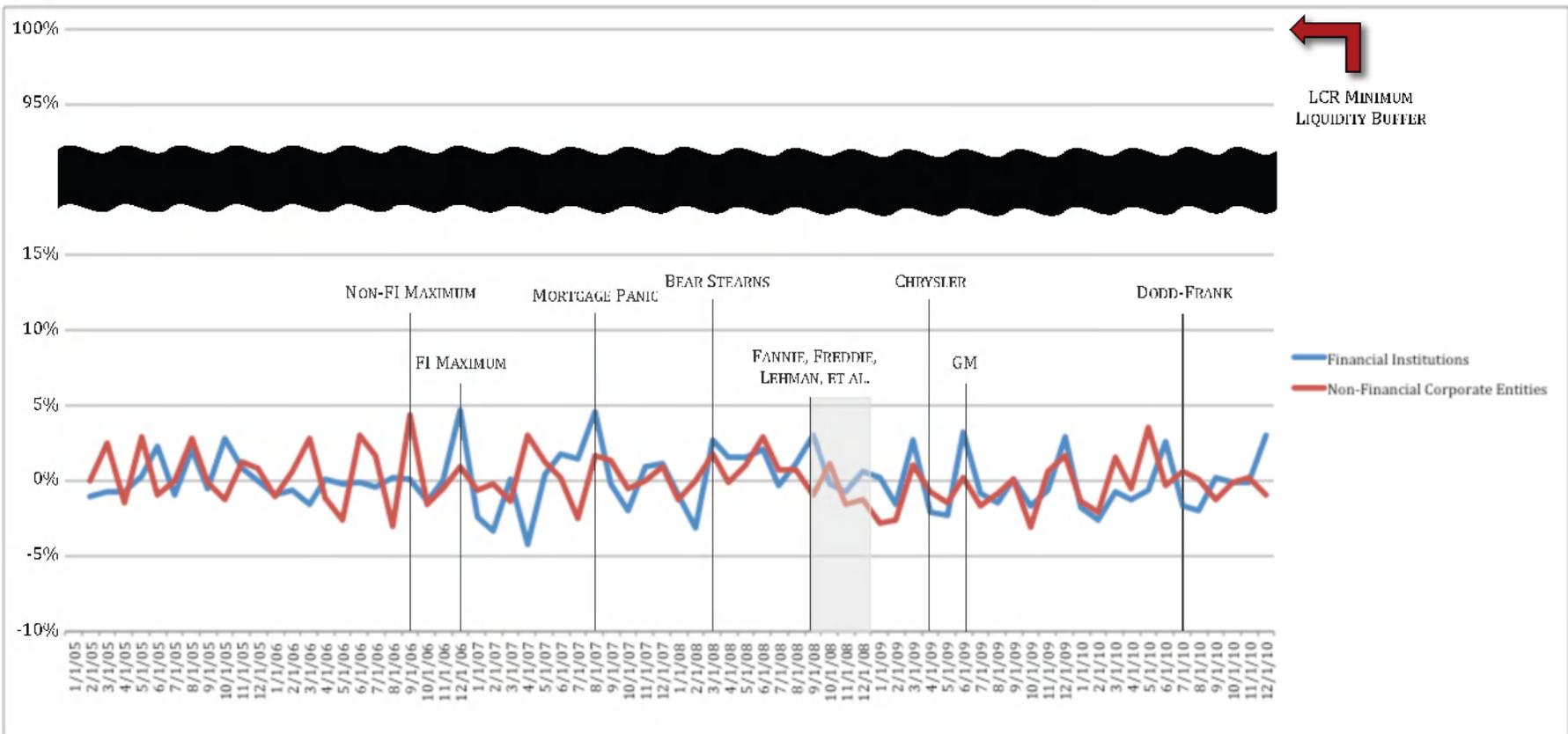
This limited risk of a surge in draws is borne out by our analysis of the aggregate change in customer usage of committed ABCP facilities.

Based on data supplied by 12 North American and European banks that sponsored ABCP conduits between January 2005 and December 2010, we found that the aggregate change in customer usage as a percentage of total commitments – even during periods of significant liquidity stress – *never exceeded 3.84% (August 2007)*.



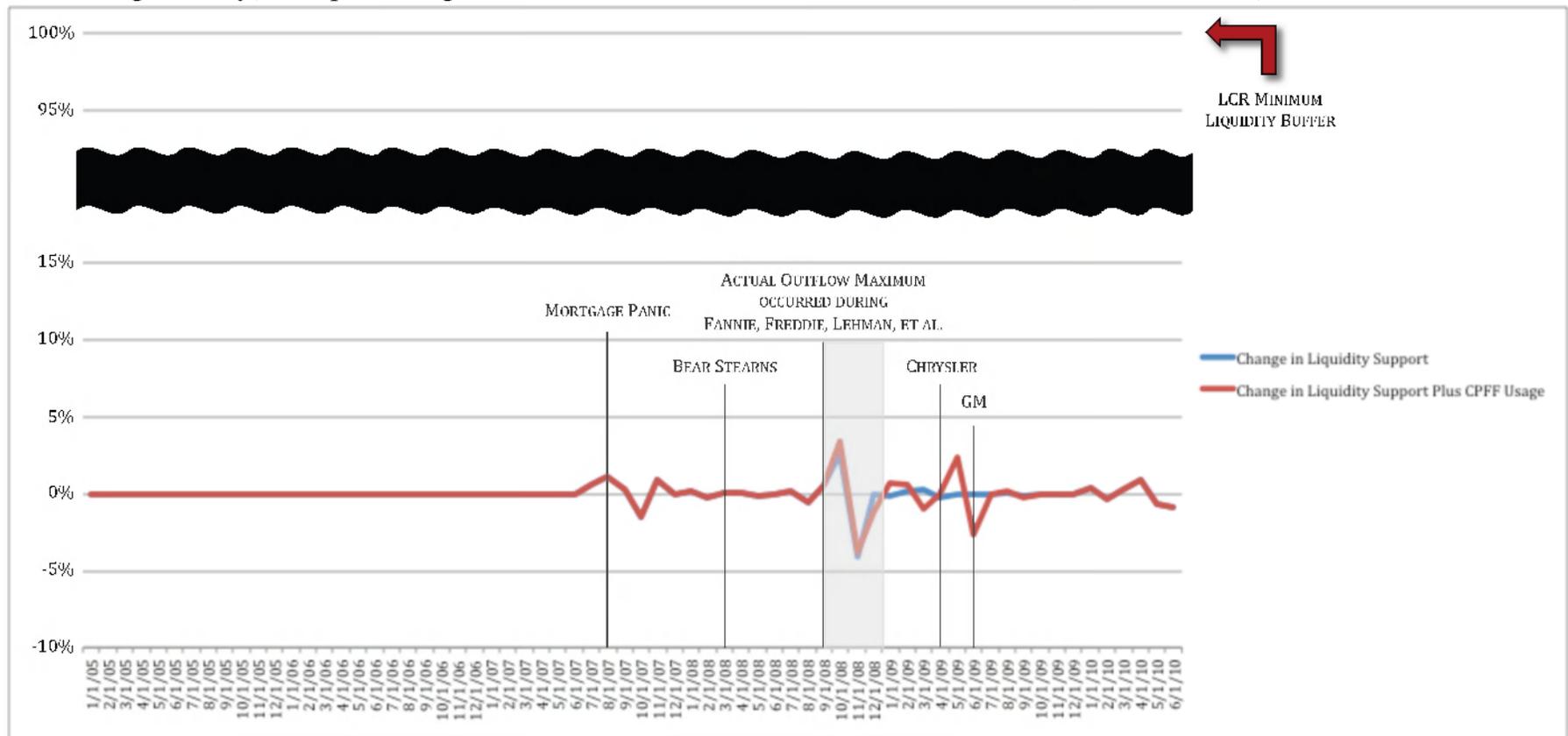
We also found no meaningful variance in the risk of a surge in draws when separating out customer-sponsor types.

Based on this same data, we found that the change in usage was not volatile and did not meaningfully vary by the type of customer-sponsor. The change in usage as a percentage of total commitments *never exceeded 4.63% for financial institutions (December 2006) and 4.39% for non-financial corporate entities (September 2006).*



Testing actual outflows from the banks themselves, in contrast to their ABCP conduits, demonstrated an even lower risk to the liquidity buffer.

We found, based on a separate set of data supplied by 12 North American and European banks that sponsored ABCP conduits between January 2005 and June 2010, that the aggregate change in actual outflows from banks (the sum of conduit liquidity draws, bank purchases of ABCP in the open market, and usage of the Commercial Paper Funding Facility) as a percentage of total commitments *never exceeded 3.44% (October 2008)*.



We endorse a conservative LCR but believe that a proper calibration is crucial to avoid unintended consequences and to mitigate harm to customers that rely on ABCP and other securitization facilities.

We endorse a conservative LCR as a mechanism for fireproofing banks against a severe liquidity crisis.

A *proper calibration of the LCR is crucial*, however, to avoid unintended consequences and, equally important, to mitigate adverse effects on the pricing and availability of credit for businesses, governments, and other customers that rely on ABCP and other securitization facilities.

- *The LCR is premised on a stress scenario that is unprecedented even in the recent crises and that would immediately prompt both political and central-bank intervention.* Under this scenario, all banks are fully drawn on most unfunded commitments, all market participants are hoarding cash, and all interbank and wholesale funding markets are closed for 30 consecutive days.
- *The LCR is a minimum standard.* Prudent capital management will compel banks to maintain a liquidity buffer that is hundreds of basis points higher than the hard 100% floor.
- *The inability to encumber Level 1 and Level 2 assets will exact a material cost.* Issuers of Level 1 and Level 2 assets (including sovereigns) will receive less favorable pricing as banks comprise an ever larger percentage of the buy-side but are prevented from financing their purchases. This dynamic also is likely to contract the repo and other markets that regulatory authorities expect will be available to convert liquid assets to cash during a crisis.
- *Redundant capital will result from the LCR's interaction with the Net Stable Funding Ratio.* Banks sponsoring securitization facilities in order to finance their customers will need to raise long-term funding under the NSFR for the commitments (5% RSF factor) and the acquired customer receivables (100% RSF factor for most) as well as liquid assets under the LCR (5% to 100% RSF factor for most).

We conclude, from both quantitative and qualitative analyses, that a targeted adjustment is warranted in connection with the draw-downs for customer usage of securitization transactions.

Under Paragraph 97(d) of the Basel III Liquidity Standard, draw-downs on the undrawn portions of committed credit and liquidity facilities to any special purpose vehicle (irrespective of its sponsor) is 100%.

Our quantitative and qualitative analyses suggest that, while financial and non-financial sponsors should continue to be treated identically, a targeted adjustment to the draw-down for securitization transactions is warranted.

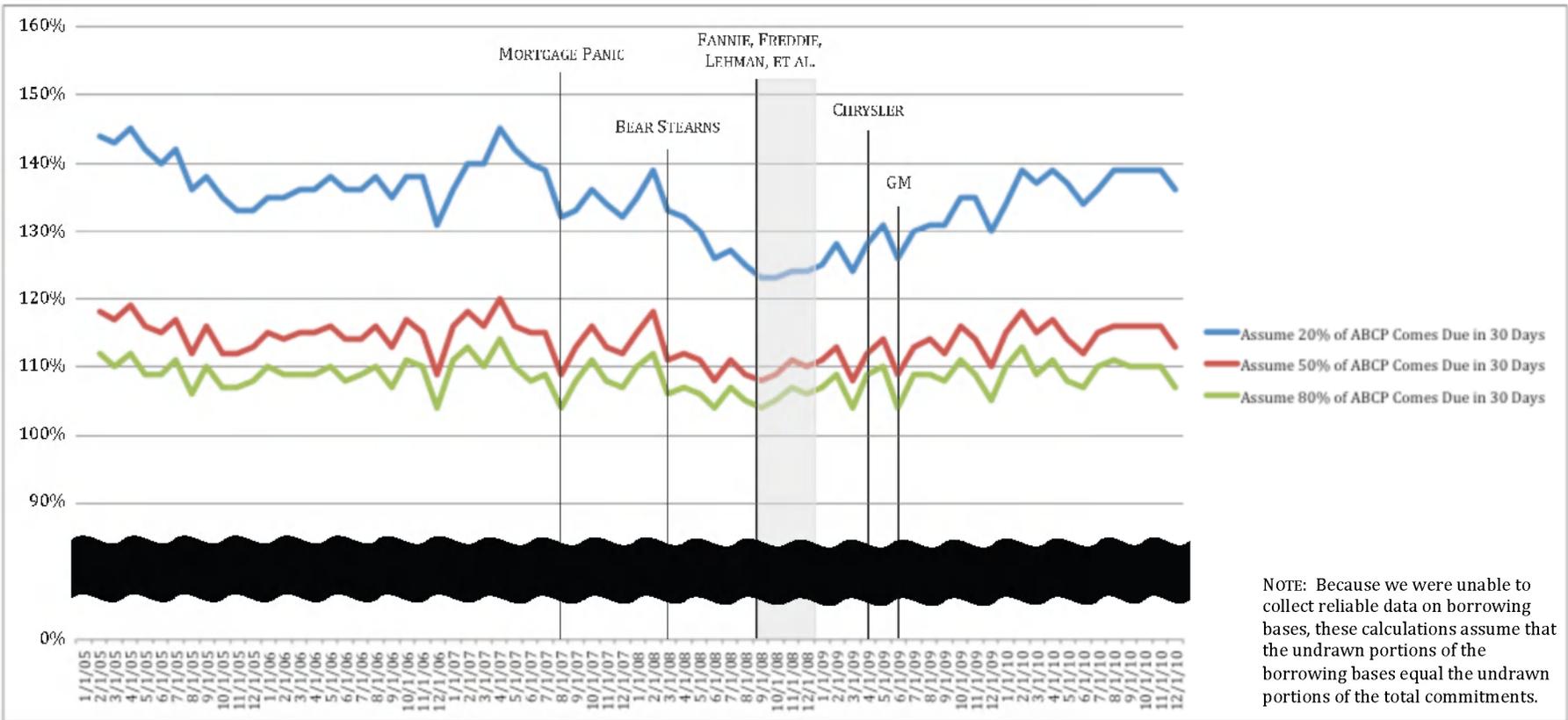
- The aggregate monthly change in customer usage, as a percentage of total commitments, never exceeded 3.84%
- The aggregate monthly change in cash outflows from banks sponsoring ABCP conduits, as a percentage of total commitments, never exceeded 3.44%.
- Dividing these by the average unused percentage of total commitments in the data set (31.32%) yields draw-downs of 12.26% and 10.98% respectively at the worst of the crises.

Imposing a draw-down for securitization transactions of 15% in Paragraph 97 of the Basel III Liquidity Standard would add to the worst experience of the recent crises a further cushion of 22% to 37%.

We also believe that the Basel III Liquidity Standard should make clear that the “undrawn portion” referenced in the LCR is the “undrawn portion of the borrowing base.” As previously noted, the pool of eligible receivables and other assets owned by the special purpose vehicle (the borrowing base) sets an upper bound on the maximum amount that remains undrawn.

Testing our proposal against the recent crises demonstrates a liquidity buffer that would have remained, at all times, comfortably higher than 100% of the ABCP coming due in 30 days.

We tested our proposal against the data to ascertain how robust a liquidity buffer would have been required by a modified LCR during the recent crises, still assuming that no ABCP could be rolled or issued for 30 days but lowering the draw-down for customer usage of securitization transactions to 15% of the undrawn portion. *As a percentage of ABCP coming due in 30 days, the buffer would have remained comfortably higher than 100%.*



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The interaction of the LCR and the proposed leverage ratio results in a duplicative capital requirement, which unnecessarily depletes the credit that can be made available to customers.

A problematic nth-order effect of the LCR arises from its interaction with the proposed leverage ratio, which results in banks being compelled to hold duplicative capital.

- The first part of the double count is due to Paragraph 162 of the Basel III Capital Standard, which provides that “commitments (including liquidity facilities)” are among the off-balance-sheet items included in the proposed leverage ratio.
 - This reflects a change even in those jurisdictions that currently have a leverage ratio (e.g., the United States and Canada).
 - Direct credit substitutes are separately covered in the proposed leverage ratio.
- The second part of the double count is due to the increase in Level 1 and Level 2 assets on each bank’s balance sheet, which must be acquired and held under the LCR to defease every commitment.
 - Notably, the cost of this required increase will be exacerbated in another second-order effect under the Basel III Capital Standard – namely, the expected rise in risk weights for sovereign exposures and other Level 1 assets that are currently set at 0%.

This duplicative capital requirement can be resolved by excluding unfunded commitments from the proposed leverage ratio.

The consequence of this treatment under the proposed leverage ratio is that, for every US\$1 in unfunded commitments, a bank would be forced to hold:

- capital under the leverage ratio on the US\$1 commitment
- $\geq 100\%$ of the US\$1 commitment in unencumbered Level 1 or Level 2 assets to defease the commitment
- capital under the leverage ratio on the \geq US\$1 of Level 1 or Level 2 assets

We note, in addition, that *the proposed Net Stable Funding Ratio would add to this double count* by requiring banks that finance their customers through ABCP or other securitization facilities to separately raise long-term funding to cover the commitments (5% required stable funding factor) and the acquired customer receivables (100% required stable funding factor for most).

As a result, we propose that Paragraph 162 of the Basel III Capital Standard exclude “commitments (including liquidity facilities)” from the leverage ratio.

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Evidence preliminarily suggests that systemic and institutional risks can be reduced if the LCR incents more diverse diversification in the Level 1 and Level 2 assets that comprise a bank's liquidity buffer.

Diverse diversification in bank liquidity buffers, including an expansion of the eligibility criteria for Level 1 and Level 2 assets, may be able to resolve a number of problematic nth-order effects of the LCR.

- Evidence suggests that herding bank investments into a narrow band of asset classes – even if perceived as optimal for an individual bank (a premise which itself has not been firmly established) – increases the probability of multiple bank failures and associated systemic and societal risks.
- If banks were compelled to build a liquidity buffer using only a narrow band of asset classes, the market for those asset classes would necessarily become illiquid as banks stockpile and refrain from trading them.
- Even as sovereign-debt issuance has reached historically high levels, it is not clear whether a sufficient inventory of Level 1 and Level 2 assets exists to enable banks to meet the LCR's minimum standard.

Evidence is beginning to mount that *this diverse diversification can be achieved while at the same time enhancing the quality of an individual bank's liquidity buffer.*

- Some asset classes whose quality was never or rarely questioned – e.g., OECD sovereign debt – have exhibited material risks.
- Other asset classes whose quality has been critiqued in a sweeping way – e.g., mortgage- and asset-backed securities – have proven to contain subsets with low credit and market risks as well as broad and deep secondary markets.

ASF has commenced a study to ascertain the optimal composition of Level 1 and Level 2 assets in the LCR. ASF also has begun to assess potentially adverse nth-order effects of the NSFR.

We have commenced a study (1) to gauge the systemic and institutional risks arising from the existing composition of Level 1 and Level 2 assets and (2) to analyze whether these risks can be reduced by altering that composition.

- Some of our considerations include (1) how does liquidity flow from sources of capital into the market for high-quality liquid assets? (2) what facilitates and impedes these channels of liquidity for particular sources of capital and particular asset types? (3) what correlations exist among sources of capital, channels of liquidity, and asset types? (4) what supplies of high-quality liquid assets exist? (5) what is the effect of varying haircuts for different high-quality liquid assets? (6) what is the effect of banks being precluded from encumbering the required stock of high-quality liquid assets?

We also have begun to assess potentially adverse nth-order effects of the Net Stable Funding Ratio.

- Under the LCR, banks that sponsor ABCP or other securitization facilities to finance their customers will need to raise Level 1 and Level 2 assets in order to defease both the customer commitments and any ABCP or other asset-backed instruments coming due in 30 days.
- At the same time, the NSFR proposes to require these banks to raise long-term funding for the same commitments (5% required stable funding factor), the acquired customer receivables (100% required stable funding factor for most), and the Level 1 and Level 2 assets (5% to 100% required stable funding factor for most).
- The NSFR also works against other regulatory initiatives (*e.g.*, Solvency II).

APPENDIX



Sources of Data for ASF's Cash-Outflow Analyses

ASF collected material data from the ABCP market, including data from the worst of the recent crises, in connection with undertaking the cash-outflow (LCR denominator) analyses.

Data was supplied to ASF by 14 North American and European financial institutions.

- Combined they hold over US\$18.6 trillion in consolidated assets (FY 2010).
- 9 were counted among the largest 50 financial institutions in the world (FY 2010).

For each data point in our cash-outflow analyses, at least 12 of these financial institutions were able to supply reliable data. We did not exclude any reliable data in conducting the analyses.

We also relied on publicly available data from the Federal Reserve Board to gauge usage of the Commercial Paper Funding Facility by these financial institutions.



Data Parameters for ASF's Cash-Outflow Analyses

Review Period: end-of-month data from January 31, 2005, to December 31, 2010

Granularity: transaction-level data

Lenders: ABCP conduits, excluding structured investment vehicles and security arbitrage vehicles, that were sponsored by financial institutions and that were active at any time during the review period

Borrowers: special purpose vehicles that were sponsored by customers of financial institutions

Customer-Sponsors of Borrowers: financial institutions and non-financial corporate entities

Categories of Facilities: trade receivables, securities, warehouse, term financing, and a catch-all "other" category