



St. Michael's House
1 George Yard
London EC3V 9DH
Great Britain/Großbritannien
Tel +44.20.77 43 93 00
Fax +44.20.77 43 93 01
www.europeansecuritisation.com

ISDA

International Swaps and Derivatives Association, Inc.
One New Change
London, EC4M 9QQ
Telephone: 44(20) 7330 3550
Facsimile: 44(20) 7330 3555
email: isda@isda-eur.org
website: www.isda.org

12. December 2001

Baseler Ausschuß für Bankenaufsicht/Basel Committee on Banking Supervision
Bank für Internationalen Zahlungsausgleich/Bank for International Settlements
CH-4051 Basel
Schweiz

Re: The New Basel Capital Accord – Synthetic Securitisation

Ladies and Gentlemen:

The European Securitisation Forum (the “*Forum*”)¹ and the International Swaps and Derivatives Association (“*ISDA*” and, together with the Forum, “*we*” or the “*Commenting Parties*”) appreciate this opportunity to comment on the synthetic securitisation aspects of the consultative proposals (the “*Consultative Proposals*”) made in the October 2001 Working Paper on the Treatment of Asset Securitisations (the “*Working Paper*”) released by the Securitisation Group (the “*Securitisation Group*”) of the Basel Committee on Banking Supervision (the “*Committee*”) in furtherance of the Committee’s work on the New Basel Capital Accord (the “*Accord*”).

This comment letter is in addition to a letter dated the date hereof from the Forum regarding the IRB securitisation proposals in the Working Paper (the “*IRB Securitisation Comment Letter*”).

1. EXECUTIVE SUMMARY

We have commented in detail below on the following points:

Standardised Approach

- The Committee needs to complete its development of rules that more fully recognise the variety in the synthetics market and conform operational and other requirements to those for traditional securitisation transactions.

¹ The European Securitisation Forum is a European financial markets trade association sponsored by The Bond Market Association (“*TBMA*”). The Forum was established to promote the continued growth and development of securitisation and to advocate the positions and represent the interests of the securitisation market throughout Europe. The Forum has a diverse membership which includes banks, securities houses, issuers, investors, rating agencies, legal and accounting firms and other professional participants active in the European securitisation markets. More information about the Forum, including its purpose and mission, its full membership and its current projects and activities, can be obtained from its website at www.europeansecuritisation.com.

- There is no reason to require that super-senior positions (which are, effectively, AAA positions or better) be hedged where a transaction has an appropriately market-tested mezzanine tranche.
- The Commenting Parties strongly oppose a full deduction of first loss from capital *and* a substitution approach on the super-senior position, as this grossly overstates the risk associated with the transaction after hedging and discriminates against synthetic securitisation transactions compared to traditional securitisation transactions.

IRB Approach

- Where external ratings exist, originators should be entitled to rely on them to determine required regulatory capital, irrespective of whether or not such positions fall within K_{IRB} .
- In the absence of external ratings, originating banks should deduct all retained positions, but not in an amount in excess of K_{IRB} .
- Investing banks should be treated as they are in traditional securitisation transactions (*i.e.*, their capital charge should be based on external ratings, inferred ratings or a top-down supervisory formula approach).

2. GENERAL COMMENTS

First, while the Commenting Parties welcome the Working Paper's proposals regarding synthetic securitisations, we are concerned that the proposals discriminate in several significant respects against synthetic securitisation transactions compared with standard securitisation transactions. For example, the proposals do not permit originating banks to recognise eligible collateral (such as cash or highly rated government securities) held against mezzanine tranches unless the mezzanine position has been acquired by more than one investor and is rated by at least two ECAIs. There is no sound reason for such discrimination, which we discuss in further detail below.

Second, even with the Working Paper there has not to date been a complete synthetic securitisation IRB proposal. For example, the Working Group is still considering how best to recognise credit risk mitigation techniques, which will form a cornerstone of the synthetic securitisation proposals. Until a complete set of synthetic securitisation proposals has been made, the Commenting Parties reserve their ability to make additional comments and to revise its existing comments on matters addressed below.

Third, the Commenting Parties reject any implicit criticism in the statement that "supervisory concern" exists regarding the "relative ease" with which banks can transfer credit risk through synthetic securitisation. Avoiding the transactional costs and complexities of traditional securitisations (which we presume provides the "relative ease" of synthetic deals observed by the Securitisation Group) does not mean that such transactions are structured or completed with any less care or attention. Instead, regulators should be pleased that there are not—in fact, regulators should discourage and should not

propose the creation of—artificial roa dbloc ks to the development of liquid credit markets that better enable banks to transfer credit risks efficiently.

Finally, the Committee should, as it further develops proposals regarding synthetic securitisation, remember that a “typical” synthetic securitisation structure does not exist. Synthetic structures include portfolio credit default swaps, tranch ed portfolio default swaps (unrated or rated), tranch ed and partially funded portfolio default swaps—in fact they all represent a continuum with a common feature: All of these structures (whether rated or not) transfer credit risk. Because they transfer credit risk, originating banks (as protection buyers) should be permitted to free up regulatory capital consistent with the amount of risk transferred and in line with credit risk mitigation principles. In addition, banks investing in these tranches should be required to maintain regulatory capital against acquired positions in line with the principles applied to cash securitisation.

The synthetic market has been tested during the current downturn and has held up extremely well. Currently, many banks are benefiting from having hedged large portions of their loan portfolios.

3. STANDARDISED CAPITAL TREATMENT

3.1 Treatment of Investors

As mentioned above, capital charges for investors should be in line with capital charges for cash securitisations. Under the Standardised Approach this would mean capital charges based on external ratings or a look-through approach or a direct deduction of capital.

3.2 Treatment of Originators

(a) *First Loss Positions*

Subject to (i) the Forum’s previous comments (including in the IRB Securitisation Comment Letter) that the required regulatory capital for retained first loss positions should not exceed the required capital for the entire pool prior to securitisation and (ii) the comments in Section 3.2(d) below, the Commenting Parties concede that first loss positions in synthetic transactions be deducted from capital.

(b) *Mezzanine Positions*

The proposal that all unrated mezzanine positions be deducte d from capital is unduly harsh and distortive. Unless a portion of the mezzanine position lies below the regulatory capital required to be held against the asset pool prior to securitisation (in which case the Commenting Parties would support deduction from capital for that portion which falls below the original required regulatory capital), there is no basis in logic or available data to support a proposal that all unrated mezzanine positions be deducted from capital.²

² For the reasons set forth in the Forum’s other comment letters, the Commenting Parties would strongly oppose any proposal that originating banks be required to deduct or hold capital against retained

For risk transfer and associated capital relief, no rating of mezzanine positions should be required at all as long as the originating bank complies with applicable credit risk mitigation requirements. Banks have been using unrated tranching and untranching portfolio credit default swaps in bilateral and private transactions since 1996 in order to manage their balance sheets, and they should continue to be able to do so. For example, an originating bank that enters into an unrated credit default swap covering a mezzanine position with an OECD bank should be entitled to recognise that counterparty's risk weighting on the mezzanine position. Provided that applicable credit risk mitigation requirements are met, these hedging strategies should result in capital relief, as they do currently. For the avoidance of doubt, this principle should also apply to subordinated positions.

Should the originating bank decide to rate the mezzanine position (for example, to support an inferred rating of the super-senior position), there is no need for the originator to obtain more than one rating. The objectives of the Committee that the rating be reliable can be met fully as long as the position has been rated by at least one ECAI.

(c) *Super-Senior Positions*

(i) *Unhedged Positions*

A requirement that the originating bank obtain third party credit risk mitigation in order to obtain risk sensitive ratings for super-senior positions is not needed to achieve the Committee's objective of reliability, and such a requirement is unnecessarily expensive. Instead, we propose that originating banks be entitled to determine the regulatory capital applicable to a super-senior tranche pursuant to any of the following methods:

- If the position is rated, the holder should be entitled to rely on that rating to determine the capital charge.³
- Alternatively, a bank should be permitted to determine inferred ratings for unrated super-senior positions not covered by eligible credit risk mitigation techniques (e.g., credit default swap) or rated.⁴ If the capital charge is based on an inferred rating, the Commenting Parties would agree that banks will need to comply with

positions in excess of the capital held against the pool prior to securitisation. We do not repeat those comments here, other than to note that there is no theoretical or empirical justification for any such increase in capital as the result of a securitisation transaction.

³ There is no need to require a "clean break" sale of the senior position in order to permit an originating bank to rely on an external rating if there is one. There is no reason to believe that an external rating is any less reliable in determining regulatory capital than either a look-through approach or a determination of capital based on a hedge or other counterparty transaction.

⁴ The Commenting Parties believe that inferred ratings should also be permitted in the case of traditional securitisations under the standardised approach. There is no reason to force banks operating under the standardised approach to ignore perfectly reliable ratings when determining the regulatory capital on a position that is senior in all respects to a rated position. There are no risk management issues involved (the position is externally, not internally, rated), and banks already have more than sufficient financial and other incentives to move to IRB qualification.

the operational requirements associated with inferred ratings as outlined in the Working Paper.

- We would also be willing to consider a look-through approach⁵ in the event that the position is not rated or hedged, but only if it gives due recognition to the significant amount of credit protection underlying the super-senior position. We would view as fundamentally unfair a look-through approach that risk weights the super-senior position on the basis of the highest or even the average risk weights of assets within the pool.

(ii) Hedged Positions

Where a super-senior position is subject to a hedge, the Commenting Parties propose that such a position be zero risk-weighted in line with the minimal economic risks inherent in that position. Otherwise, the regulatory capital required to be held against the pool would grossly overstate the economic risks involved in that portfolio.

After members of the Working Group asked during our meeting last week that we think about a compromise, the Commenting Parties have concluded that they would consider rules adopting a conversion factor that would be applied against a super-senior position before assessing the required capital. Fitting the super-senior position in the existing 20% risk weight “bucket” is simply too heavy-handed an approach for these positions, and an appropriate conversion factor could be determined on the basis of, and should reflect, the particularly remote set of risks inherent in that position.

Alternatively, we have recommended a further approach in Section 3.2(d) below.

(d) Alternative Approach

The Committee may wish to consider adopting regulatory capital calculation methods that achieve the substance of the rules contained in the letter dated November 15, 1999 of the Office of the Comptroller of the Currency/Federal Reserve entitled “Capital Interpretation Synthetic Collateralized Loan Obligations to determine capital for senior positions that are hedged.” In that letter, the OCC/Federal Reserve describe a synthetic securitisation transaction in which the originating bank retains a 1% first loss position, collateralises the mezzanine position with U.S. Treasury securities, and hedges the super-senior position with an OECD bank. The letter requires the originating bank to hold capital against its entire position on the basis of the “higher of” the capital weighting requirement of the following two approaches:

- Under the first approach, the first loss position would be fully deducted from capital and there would be no capital charge for the rest of the capital structure. This approach equates to a “substance over form” approach that recognises that super-senior positions are virtually risk-free.

⁵ We view a look through approach as, essentially, the equivalent of internal portfolio modelling.

- The second approach would employ a literal reading of the capital guidelines to determine the sponsoring bank's risk-based capital charge. In the example given, the 1% retained first loss position would be treated as a direct credit substitute and assessed an 8% capital charge against its face value. The second loss position, collateralised by U.S. Treasury securities, would be subject to a zero percent capital charge. The super-senior loss position guaranteed by an OECD bank would be assigned to the 20% risk category and risk weighted accordingly. This approach equates to a "form over substance approach" under current BIS guidelines.

This approach would effectively mean that the capital charge cannot fall to less than approximately 1.6% (equivalent to a 20% risk-weighting of the super-senior tranche), if the first loss position is lower than that. Transactions with first loss positions higher than 1.6% would attract a higher capital charge in line with deducting first loss from capital (which is very conservative), but would avoid a capital charge on the virtually risk-free super-senior position. This methodology assesses a transaction as a whole, and is risk-sensitive and prudent at the same time. It is also the answer to potential concerns that the counterparty risk on the super-senior tranche is not reflected at all.

What the Commenting Parties strongly oppose is a full deduction of first loss from capital *and* a substitution approach on the super-senior position (*i.e.* a 20% risk weighting), as this grossly overstates the risk associated with the transaction after hedging and discriminates against synthetic securitisation transactions compared to traditional securitisation transactions. It would also move the market in 2005 back to a regulatory capital regime that is stricter than that in place in Europe (*de facto*) and in the U.S. based on the November 1999 regulations.⁶

4. IRB TREATMENT OF SYNTHETIC SECURITISATIONS

Originating Banks. The Commenting Parties believe that, where external ratings exist, originators should be entitled to rely on them to determine required regulatory capital, irrespective of whether or not such positions fall within K_{IRB} . In other words, where an external rating exists, originating banks should not be required to deduct the entire position even if it falls between zero and K_{IRB} . In the absence of external ratings, we agree that originating banks should deduct retained positions, but not in an amount in excess of K_{IRB} .

Investing Banks. Investing banks should be treated as they are in traditional securitisation transactions (*i.e.*, their capital charge should be based on external rating or inferred ratings or a top-down supervisory formula approach). As mentioned above, the Commenting Parties await more detailed proposals on a workable top-down IRB framework for investors, specifying in particular the information required in order for the investor to be able to determine K_{IRB} .

⁶ As mentioned at our recent meeting, a number of European regulators have adopted practice guidelines that permit capital treatment in a manner similar to the 1999 Regulations adopted by the U.S. regulators.

5. OPERATIONAL REQUIREMENTS

We have the following observations on several of the operational requirements set forth in the Working Paper.

- For the reasons mentioned elsewhere, the requirements that there be more than one counterparty and ratings from more than ECAI are unnecessary and excessive. The Commenting Parties believe that bi-lateral transactions where credit risk is actually transferred should be afforded regulatory capital relief just as any other risk transfer.
- As mentioned above, the proposals need to include rules dealing with synthetic securitisation transactions that are wholly unrated, private, unfunded transactions. Such transactions are an important part of the market and the Working Paper's statements (on page 21) that the transaction must be subject to market discipline through the "issuance" of exposures to "the capital markets" should be clarified or modified appropriately to permit such transactions explicitly in a risk sensitive manner.
- There is no justification for singling out credit-linked notes for special treatment, as implied in clause (e) on page 21 of the Working Paper. Economically, credit linked notes are the funded version of credit derivatives.
- Early amortisation features should be permitted in synthetic transactions just as in cash securitisation, provided that, as a result of such amortisation, the assets do not go back onto the balance sheet of the originator or the contractually mandated level of recourse against the originator otherwise increases. Moreover, for the reasons referred to above in connection with the proposed managed assets approach, there should not be any penalty for revolving features in either synthetic or cash structures.⁷ As mentioned above, as far as we are aware there is no regulatory precedent for requiring capital against theoretical and non-contractually binding future commitments. Early amortisation features are in effect liquidity provisions that neither render the transferred assets more risky nor modify the then-existing obligations (if any) of the originator with respect to recourse.
- The proposal that sponsoring banks not reassume any credit risk associated with positions issued to the markets is acceptable if such reassumption is at a below market price.
- The proposal that a structure not contain provisions increasing the retained first loss position needs to be clarified to account for certain customary aspects of synthetic transactions, including (a) an absolute increase (but not an increase as a

⁷ We draw the Committee's attention to an important distinction between a revolving securitisation structure—to which the proposed managed assets approach would apply—and the replenishment of term assets in a securitisation transaction which should be left wholly outside of the managed assets proposals in the Working Paper.

proportion of the entire portfolio) in the first loss position during any ramp-up period, (b) an increase in the first loss position as a proportion of entire portfolio during any amortisation period, and (c) an increase in the first loss position resulting from excess spread accumulation.⁸

- The Working paper proposes that a legal opinion be required “to ensure that the synthetic securitisation structure transfers the risk” involved. Please confirm exactly what is meant by this language, as legal opinions typically address the enforceability of specific documentation (based on customary assumptions and qualifications) not that a particular structure transfers risks in satisfaction of a regulatory standard. Opinions in arm’s length transactions also create excessive costs. In the event that opinions (in customary form) are required, we recommend that those delivered by internal legal counsel be sufficient, or those delivered by counsel in connection with the preparation of the model agreements used to document the actual transactions with respect to which regulatory capital is being determined.

Should you wish to communicate with either of the Commenting Parties or any of their members on any issue, please feel free to contact either Scott Rankin, Managing Director of the European Securitisation Forum, at +44 20 77 43 93 00 or via email at srankin@bondmarkets.com, or Emmanuelle Sebton, Head of Risk Management of the International Swaps and Derivatives Association, at +44 20 73 30 35 55 or via email at esebton@isda-eur.org

Respectfully submitted,

Scott C. Rankin
Managing Director
European Securitisation Forum

Emmanuelle Sebton
Head of Risk Management
International Swap and Derivatives Association

⁸ The Commenting Parties recommend that the suggestions made in this Section apply to traditional securitisations as well.