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16 February 2004

Dear Quentin

Securitisation in Basel

We are writing on behalf of The British Bankers' Association, The London Investment Bankers' Association and the International Swaps and Derivatives Association (the Associations) to thank you for meeting with us and some of our members last week to discuss the Basel Committee's most recent proposals on the Securitisation framework. This letter confirms some of the views expressed at the meeting - we hope it is useful in your discussions in New York.

The Internal Assessment Approach

The newly developed Internal Assessment Approach is a helpful initiative to accommodate ABCP conduits. We support the extension of its scope to include a wider range of liquidity facilities and credit enhancements. This will increase the IAA approach's utility for the industry significantly. We recognise too that more information is required on how the top down approach will be implemented so that our members can ensure they meet the required operational standards for deriving internal assessments based on Rating Agency methodologies.

SFA versus Simplified SF

The Simplified SF is computationally simpler, although not as conceptually robust as the original SFA. It also results in more onerous capital charges.

The proposed SF is in effect a numerical integral whose calculation involves defining a factor I to use for integration. The proposal discusses allowing banks to choose a value for I subject to supervisory approval. By contrast, integration in the original SFA was performed analytically.

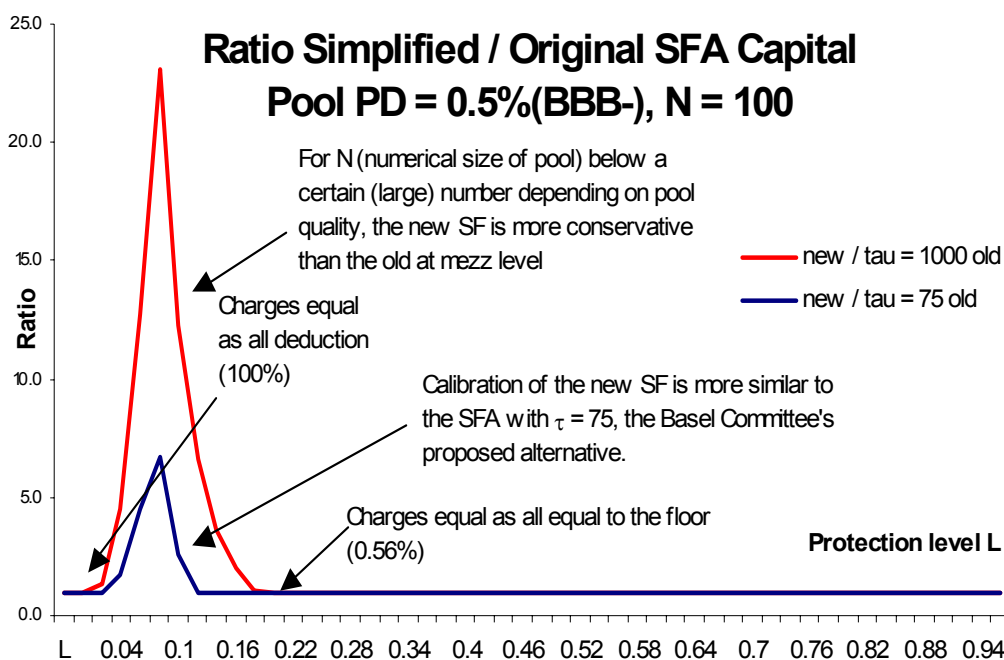
The capital charge decreases systematically for increased I . When applying the simplified SF to the calculation of the charge on a senior tranche, it is necessary to use a very large value for I to obtain a charge broadly comparable with the old SFA requirement.

We have run a simple simulation, calculating the capital charges under the simplified SF, SFA and RBA for a portfolio of 100 unit exposures, of average PD equal to 0.5%. I was set equal to 1 (worst case), and Tau, to 1000. The resulting risk weights are as follows.

Tranches	Risk Weights		
	SF Charge	SFA	RBA
First loss	1250%	1250%	1250%
Mezzanine (AA)	1110%	715%	15%
Senior (AAA)	485%	7%	7%

(see Appendix for more detail)

If I was set to infinity (best case), the senior tranche would still attract a risk weight of 28.6%, instead of 7% under the current SFA, and 11.5% under a recalibrated SFA (Tau =75). A comparison of the simplified SF with the SFA is provided in the following chart (Source: Credit Suisse First Boston) for two different values of tau (1000 and 75).



In addition, the RBA risk weights produce a capital charge smaller than both supervisory formulas. This implies that there is no incentive for firms to use the supervisory approach, at least in the specific example under consideration.

We conclude that:

- 1- The calibration of the Simplified SF using $I=1$ is not suitable in practice- high values of I must be allowed in order to obtain reasonable charges.
- 2- The Associations strongly recommend maintaining the current SFA in light of the lack of a conceptual basis for the Simplified SF, the confusion introduced by the choice of I, and the conservativeness of the approach.

3- Finally, the SFA appears punitive by comparison with the RBA. This is because (i) ratings below K_{irb} are assigned a lower than 1250% risk weight under the RBA in a number of transactions, and (ii) high quality mezzanine tranches receive a penal treatment under the SFA. To introduce greater consistency between the two approaches, the Associations would like to reiterate their plea in favour of not deducting tranches below K_{irb} under the SFA. This would furthermore contribute to simplifying the formula greatly, as the regulatory charge would reduce to function $K(L)$ in CP3¹.

Seniority vs. Thickness

We support the replacement of the thickness parameter with seniority, which is easy to understand and reflects the reality that senior tranches are generally thicker anyway

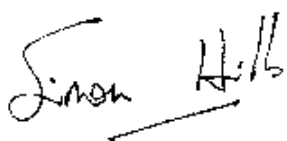
EL-UL

One inconsistency in the proposed treatment of securitisation tranches lies in the treatment of EL for originating banks. EL is normally provisioned against prior to securitisation. If, following securitisation, an originating bank re-acquires exposure to EL as part of the equity tranche, half of the corresponding exposure must be covered by Tier 1 capital.

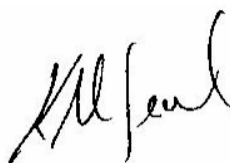
This inequality of treatment will contribute to reducing the attractiveness of securitisation as a risk mitigation technique. It also seems conceptually unjustified.

We do hope you and your colleagues have a successful meeting in New York and look forward to hearing of the results soon.

Yours sincerely



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¹ See for reference Annex D to a joint ISDA-ESF letter to the Basel Committee on QIS3, dated 13 January 2003, available at www.isda.org

-APPENDIX-

SECURITISATION FRAMEWORK- COMPARING SFA WITH SF

Pool :	
N	100 (number of unit exposures)
Average PD	0.50%
Average LGD	45%
Correlation	21%
Kirb	4.40
Tranching	
0-Kirb	4.40 (First loss)
Kirb-X	0.60 (Mezzanine)
X-100	95 (AAA equivalent)

Cumulative tranches	SF risk weights	Charges per \$ of notional		
		SF Charge	SFA	RBA
0		0.04	0.04	0.04
4.40	0.043982069	0.04	0.04	0.04
5.00	11.09548238	0.00534175	0.003442	7.22152E-05
100.00	4.845482376	0.36825666	0.00532	0.00532
		0.42	0.05	0.049374284

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	SF Charge	SFA	RBA
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Setting X

Assuming independence in default in pool (consistent with some rating agencies' methodology)

Number defaults	Probability	Combinations	density function	
1	0.003044073	100	30.441%	39.423%
2	1.52968E-05	4950	7.572%	8.982%
3	7.68686E-08	161700	1.243%	1.410%
4	3.86274E-10	3921225	0.151%	0.167% AA
5	1.94108E-12	75287520	0.015%	0.016% AA test 0.5% average PD
6	9.75415E-15	1192052400	0.001%	0.001%
7	4.90159E-17	16007560800	0.000%	0.000%
8	2.46311E-19	1.86088E+11	0.000%	0.000%
9	1.23774E-21	1.90223E+12	0.000%	0.000%
10	6.21981E-24	1.73103E+13	0.000%	0.000%
11	3.12553E-26	1.4163E+14	0.000%	0.000%
12	1.57062E-28	1.05042E+15	0.000%	0.000%
13	7.89256E-31	7.11054E+15	0.000%	0.000%
14	3.96611E-33	4.41869E+16	0.000%	0.000%
15	1.99302E-35	2.53338E+17	0.000%	0.000%
16	1.00152E-37	1.34586E+18	0.000%	0.000%
17	5.03275E-40	6.65013E+18	0.000%	0.000%
18	2.52902E-42	3.06645E+19	0.000%	0.000%
19	1.27087E-44	1.32342E+20	0.000%	0.000%
20	6.38626E-47	5.35983E+20	0.000%	0.000%
21	3.20918E-49	2.04184E+21	0.000%	0.000%
22	1.61265E-51	7.33207E+21	0.000%	0.000%
23	8.10377E-54	2.48653E+22	0.000%	0.000%
24	4.07225E-56	7.97761E+22	0.000%	0.000%
25	2.04636E-58	2.42519E+23	0.000%	0.000%
26	1.02832E-60	6.99575E+23	0.000%	0.000%
27	5.16743E-63	1.91735E+24	0.000%	0.000%
28	2.5967E-65	4.99881E+24	0.000%	0.000%
29	1.30487E-67	1.24108E+25	0.000%	0.000%
30	6.55716E-70	2.93723E+25	0.000%	0.000%
31	3.29506E-72	6.63246E+25	0.000%	0.000%
32	1.65581E-74	1.43013E+26	0.000%	0.000%
33	8.32064E-77	2.94692E+26	0.000%	0.000%
34	4.18122E-79	5.80717E+26	0.000%	0.000%
35	2.10112E-81	1.09507E+27	0.000%	0.000%
36	1.05584E-83	1.9772E+27	0.000%	0.000%
37	5.30572E-86	3.42003E+27	0.000%	0.000%
38	2.66619E-88	5.67005E+27	0.000%	0.000%
39	1.33979E-90	9.01392E+27	0.000%	0.000%
40	6.73263E-93	1.37462E+28	0.000%	0.000%
41	3.38323E-95	2.01164E+28	0.000%	0.000%
42	1.70012E-97	2.82588E+28	0.000%	0.000%
43	8.5433E-100	3.81165E+28	0.000%	0.000%
44	4.2931E-102	4.93782E+28	0.000%	0.000%
45	2.1573E-104	6.14485E+28	0.000%	0.000%
46	1.0841E-106	7.3471E+28	0.000%	0.000%
47	5.4477E-109	8.44135E+28	0.000%	0.000%
48	2.7375E-111	9.32066E+28	0.000%	0.000%
49	1.3756E-113	9.89131E+28	0.000%	0.000%
50	6.9128E-116	1.00891E+29	0.000%	0.000%
51	3.4738E-118	9.89131E+28	0.000%	0.000%
52	1.7456E-120	9.32066E+28	0.000%	0.000%
53	8.7719E-123	8.44135E+28	0.000%	0.000%
54	4.408E-125	7.3471E+28	0.000%	0.000%
55	2.2151E-127	6.14485E+28	0.000%	0.000%