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American Securitization Forum Letter to OTS

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November 17, 2003



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Robert E. Feldman
Executive Secretary
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Chief Counsel's Office
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Attn: 2003-27 and 2003-48

Re: Interim Capital Treatment of ABCP Program Assets/Permanent Capital Treatment of ABCP Program Assets

The American Securitization Forum thanks the member agencies (the "Agencies") of the Federal Financial Institutions Examination Council for this opportunity to comment on two related regulatory capital releases published in the Federal Register on October 1, 2003: (i) the interim final rule on interim capital treatment of asset-backed commercial paper ("ABCP") program assets (the "Interim Final Rule") and (ii) the proposed rule on permanent capital treatment of ABCP program assets (the "Proposed Permanent Rule").

We agree with the Agencies that without an adjustment to the risk-based capital rules, the regulatory capital applicable after giving effect to FIN 46¹ would exceed that necessary to address the risks of a bank's exposure to ABCP program assets. We greatly appreciate the hard work of the Agencies to provide the interim regulatory capital relief set forth in the Interim Final Rule.

Our primary comments are to the Proposed Permanent Rule, although one technical comment discussed in Part F below, relates to both the Interim Final Rule and the Proposed Permanent Rule. Our points are set forth as follows:

¹ Interpretation No. 46, "Consolidation of Variable Interest Entities" issued by the Financial Accounting Standards Board (FASB) in January 2003.

- In Part A we advocate the delay of the implementation of the proposed treatment of liquidity positions and facilities with early amortization provisions until the implementation of the Accord in the U.S.
- In Part B, we advocate the adoption of an internal bank rating approach for determining required capital for liquidity positions.
- In Part C, we suggest a more appropriate conversion factor for liquidity positions than that proposed.
- We discuss the appropriate requirements for “eligible” liquidity facilities in Part D.
- Our comments on the early amortization capital requirements are set forth in Part E.

Finally, we have three technical comments set forth in Part F. We note that our comments in Parts B through E only apply if the Agencies do not defer the implementation of the proposed changes until the adoption of the Accord in the U.S.

A. Proposed should be implemented only when the revised Accord is adopted

While we understand the Agencies’ desire to move the regulatory capital rules to a more risk-sensitive approach, we believe that the proposed changes for treatment of liquidity facilities and revolving transactions with early amortization features should be made in the context of the U.S. implementation of the revised Basel Accord (the “Accord”). With the ongoing work in developing the final framework that will govern risk-based capital requirements for all securitizations under the Accord, it strikes us as unfair to adopt portions of the Accord which will impose additional capital requirements on one subset of providers of funding through one particular type of securitization. As one of the fundamental premises of the Accord is to maintain consistency within and throughout jurisdictions in minimum capital requirements, we believe that it is inappropriate to adopt portions of the Accord prior to the international implementation date. Not only will the early adoption of these proposals put U.S. banks at a competitive disadvantage to foreign banks, it will also add additional costs to funding through an ABCP conduit, making it a less efficient funding source for customers. Given the relatively low risk of liquidity positions for conduit transactions, we believe it is inappropriate that these commitments attract a higher capital charge than other short-term commitments, such as a back-stop facility to a corporate borrower for its commercial paper issuances.

First, the 20% conversion factor is simply the substitution of one arbitrary line for another (the current 0% conversion factor). In effect, the proposal for liquidity facilities is an adoption of the Standardized Approach under the Accord—an approach that the Agencies have themselves rejected in their initial implementation proposal for the Accord in the U.S. For reasons discussed in Part C below, we strongly believe that the true risk of liquidity positions is closer to a 0% conversion factor than a 20% factor. Second, there are several practical problems in the proposal relating to the definition of eligible liquidity facilities—several of which are different than those within the proposed Accord. While we discuss the specifics of the problems below, we note that any proposal that would change the standards for liquidity facilities will take time for banks to implement for existing facilities either through an amendment process or as these facilities are renewed.

We understand that the Basel Committee on Banking Supervision received over 200 letters on the latest draft of the proposed Accord and that the Committee is considering revising the Accord to eliminate or simplify the SFA in whole or in part for securitizations in order to replace all or portions of that approach with a less complex approach. We do not believe that it makes sense to change the capital requirements now when we know that within the next couple of years they will be ultimately changed again upon adoption of the Accord in the U.S., especially given the relatively low risk of liquidity positions. Therefore, we request that the Agencies preserve the status quo until the adoption of the revised Accord in the U.S. We believe that the additional time provided will allow for a more fully developed, risk sensitive proposal, less disruption for banks and their customers in the implementation and less potential damage to the U.S. ABCP conduit market due to the competitive disadvantage as a funding source within the U.S. and the competitive disadvantage as to which U.S. banks would be put as compared to their foreign competitors.

B. Adoption of an Internal Bank Rating Approach

If the Agencies were not willing to delay the implementation of the revised capital requirements in the Proposed Permanent Rules until the adoption of the revised Accord, we recommend the adoption of an internal ratings approach for determining the risk weights applicable to liquidity facilities. The benefits of the adoption of such an approach are two-fold. First, we believe that a bank's internal system is the best method for determining the risk of a liquidity exposure. Second, the early adoption of an internal ratings based system will give all regulators a chance to become comfortable with the internal approach for broader adoption at the Accord level.

Our proposal expands to liquidity commitments the internal approach currently in place in the United States for credit 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. We expect that if the Agencies were to adopt this approach there would need to be a reasonable delay in the implementation of the Proposed Permanent rule to allow for regulators to approve a bank's internal system. We don't believe that this would require more than a year given the work that has already been done by the regulators in reviewing internal systems under the current rules for credit enhancement exposures.

Under our proposal, banks 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. These internal ratings would then be used to determine the risk weight for the liquidity position based on the ratings table proposed under the Accord, with reductions in the risk weights we requested in our comment on the advance notice of proposed rulemaking relating to the U.S. implementation of the Accord (the "ANPR"), a copy of which we submit herewith.² Capital would then be determined by applying the appropriate credit conversion factor, which we discuss below, to the applicable risk weight from the ratings table.

C. Appropriate Conversion Factors

Whether or not the Agencies are willing to permit an internal bank rating approach at this time, we believe that the proposed 20% conversion factor is too high in light of the risks of these positions. As discussed in part 3(C) of our comment on the ANPR, we strongly feel that the asset quality tests present in liquidity facilities, coupled with 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, significantly reduce the level of exposure by a liquidity bank to the risks in the related portfolio.

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

² See part I of our comment to the ANPR for our discussion of the proposed ratings table.

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 responding banks act as sponsor of a conduit, representing approximately 0.067% of all originations of those banks.
- 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 the proposed capital charge against liquidity will put United States banks at a competitive disadvantage vis a vis foreign banks as well as other funding sources within the U.S., the need for an appropriately calibrated credit conversion factor is heightened during this interim period prior to the adoption of the Accord. Additionally, in order to preserve the availability of an important risk dispersing technique, namely the syndication of portions of a liquidity facility to third party providers, the capital charge for these positions cannot exceed what banks generally hold as economic capital against a position. While a sponsor that provides liquidity has a broader interest in an underlying transaction, the third party liquidity provider's interest is limited to the particular transaction for which it provides liquidity support. If that position becomes uneconomic to take on, the liquidity syndication market is likely to disappear.

We believe that a conversion factor of between 5 to 10% is the appropriate level to set for minimum capital requirements for these very safe positions.³

D. Definition of Eligible Liquidity Facilities

In addition to our concerns over the appropriate credit conversion factor for liquidity facilities, we have several issues with the eligibility requirements for liquidity. First, while a 60 day delinquency standard may be appropriate in the context of some trade receivables transactions, it is not appropriate in all such transactions or for other asset classes. For example, a credit card transaction might have a 120 day delinquency standard. Rather than a "one-size fits all" definition, we believe it is more appropriate to tie the limitation to not permitting funding against assets that would be characterized as "defaulted" by the bank. We note that this is the standard currently proposed both in the Accord and in the proposed U.S. implementation of the Accord and see no justification for a different standard during the interim. Second, we do not believe the limitation that prohibits draws under the facility that supports a rated security when that security's rating falls below investment grade is appropriate. First, if the rating is not the asset quality test used for a liquidity facility, it is irrelevant to assuring that liquidity positions do not fund against bad assets. For example, if the relevant asset quality test reduces the purchase price paid under a liquidity facility dollar-for-dollar for the amount of defaulted receivables being funded, whether that transaction is rated AAA or BB, the liquidity position is protected from funding bad assets. Second, even when a rating is used as the asset quality test for a liquidity facility, the proposed limitation is unnecessary—as the risk of a position increases more capital will be required to be held against related exposures. For example, for a \$10,000,000 liquidity position, the required capital under the current proposal would increase from \$32,000 ($8\% \times 20\% \times 20\% \times \$10,000,000$) to \$320,000 ($8\% \times 20\% \times 200\% \times \$10,000,000$) if the rating of the underlying transaction fell from AAA to BB.

If the Agencies were unwilling to eliminate investment grade funding threshold for rated securities in its entirety, we suggest that (i) it should only be applicable in transactions where the asset quality test ties to a rating of an exposure (or guarantor), (ii) when it is applicable, the requirement that liquidity should not fund against defaulted assets should not apply (as it is irrelevant to the ratings asset quality test), (iii) a more appropriate trigger should be when a position falls below BB, given that the average rating of corporate loans held by United States banks is in the area of BB

³ We are asking for a revised conversion factor along with revised risk weights with the goal of some combination that results in an ultimate calculation of minimum capital that is appropriate for a particular position.

and (iv) rather than eliminating from “eligible liquidity facilities” those that permit funding below the specified trigger, a more appropriate limitation would be to eliminate the credit conversion factor from the calculation of required capital for the related liquidity facility once the rating fell below the specified trigger.

E. Early Amortization Capital Requirements

If the Agencies were unwilling to delay the implementation of the capital requirements for revolving retail transactions until the implementation of the Accord in the U.S., we have several comments on the proposal set forth in the Proposed Permanent Rule. First, we believe that the Agencies must recognize and establish an alternative approach for controlled early amortization transactions similar to the approach specified in the proposed Accord. Unlike the proposal in the Accord, however, banks should be able to utilize this approach so long as they can meet certain more limited and objective, principles-based criteria. To meet the necessary conditions for “controlled early amortization” an originator should be required to show only that: (i) the period for amortization is sufficient for 90% of the total debt outstanding at the beginning of the amortization period to be repaid or recognized as in default and (ii) the amortization occurs at a pace no more rapid than a straight-line amortization.

The Agencies 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 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 rules for amortization provisions should provide regulators with sufficient flexibility to apply appropriate modifications to the amortization rules when the context requires.

Third, we recommend a simplification of the conversion factor early amortization capital requirement that would make implementation much easier and that would

prevent the unintended result of incentivizing a bank to establish lower triggers to avoid capital charges. The 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. Conversely, the proposal as drafted gives a bank an incentive to establish lower triggers for trapping excess cash to avoid the early amortization capital charges associated with higher triggers. We believe that prudent risk mitigation should drive the establishment of appropriate triggers, not minimum capital requirements. 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 conversion factors for the segments for controlled amortization structures be the same as proposed in the ANPR (0%, 1%, 2%, 20% and 40%). We also recommend a reduction to the required conversion factors for non-controlled early amortization risk. The following conservative conversion factors for these early amortization structures: 0%, 2%, 4%, 40%, and 80% would represent a more appropriate risk differential than those currently proposed.

F. Technical Comments

1. Definition of ABCP Program.

We note that in both the Interim Final Rule and the Proposed Permanent Rule there are differences between the definition of an ABCP program by the OTS and OCC, on the one hand, and the FDIC and FRB, on the other hand. The OTS and OCC have adopted a definition that is sufficiently broad in scope to cover all types of conduits affected by FIN 46—bankruptcy remote special purpose entities that issue commercial paper to fund the assets held by that entity. Rather than adopting this definition, the FRB and FDIC's proposed definition describes the "typical" conduit, which is a multi-seller conduit funding customers through loans or purchases of asset pools. It is unclear from a definition that describes the typical conduit whether the FRB and FDIC intended to exclude other types of conduits from regulatory capital relief. While a vast majority of conduits are structured as described by this definition, there are a number of bankruptcy remote conduits, such as structured

investment vehicles, which fund the purchase of securities issued in the capital markets through the issuance of ABCP. The distortive effects of FIN 46 consolidation apply equally to all types of conduits. Therefore, we believe that it is appropriate that the capital relief should apply to all conduits. We request that the FDIC and FRB adopt the definition of an "asset-backed commercial paper program" as defined by the OTS and OCC or, at a minimum, clarify that the definition used in their proposals was not meant to be exclusive of conduits that do not fall into the "typical" structure.

2. Determining Risk Weight for Unrated Transactions

If an internal bank rating approach is not adopted, we believe that the Proposed Permanent Rule needs to provide a mechanic for determining the risk weight for liquidity facilities that support unrated transactions. Liquidity facilities generally support a pool of receivables and related obligors. We believe that the appropriate risk weight for the pool should be the weighted average risk weight of the underlying obligors. This weighted average risk would reflect the true risks in the portfolio.

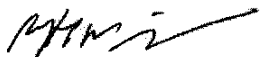
3. Extension of Implementation Deadline

We ask that the April 1st deadline be extended to at least one year past the adoption of the Proposed Permanent Rules to permit any required changes in liquidity facilities to be implemented as these facilities come up for renewal rather than require a potentially conduit wide amendment process within the next several months. This extension would also permit the adoption of the internal bank rating approach that we advocate. At a minimum, we propose that all existing liquidity facilities be deemed to be "eligible" facilities until the earlier to occur of (i) an amendment to that facility or (ii) the first renewal date for such facility following the effective date of the new rules to allow for an orderly implementation of the new requirements for liquidity facilities in the current market.

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We appreciate this opportunity to comment on the these proposals.



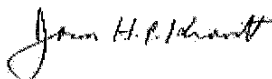
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