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April 17, 2009

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland

Delivered via e-mail to baselcommittee@bis.org

RE: Response to consultative document, *"“Proposed enhancements to the Basel II framework” (BCBS 150).*

Ladies and Gentlemen:

Thank you for providing The Risk Management Association (RMA) the opportunity to comment on the Basel Committee on Banking Supervision's consultative document "“Proposed enhancements to the Basel II framework” (BCBS 150) published in January 2009. RMA, a member-driven professional association, helps banking and nonbanking institutions identify and manage the effects of credit risk, operational risk, and market risk on their businesses and customers.

We agree in general with the thrust of the Consultative Document that ratings constitute only a “start” of risk analysis and that banks should understand the risk of the underlying pool assets as well as the nature of the securitization “waterfall.” Despite the general agreement, we have some significant concerns regarding implementation that are discussed in the text of the response.

Please feel free to contact Ed DeMarco at 215-446-4052 or via email at edemarco@rmahq.org or Sue Wharton, at 215-446-4089 or via email at swharton@rmahq.org.

Sincerely yours,

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I. Introduction

The RMA Capital Working Group is pleased to respond to the January 2009 Consultative Document "Proposed enhancements to the Basel II framework" (BCBS 150). Our group consists of senior officers working in the area of risk measurement and management at the major banking institutions in the U.S. and Canada.[1] We continue to be staunch proponents of the Basel II process, including the rigorous measurement of all risks, including credit risk. This response concentrates primarily on the proposed changes to the treatment of capital requirements for securitization positions. As such, our response, while focusing on BCBS 150, also takes into account the proposals with regard to "Revisions to the Basel II market risk framework," (BCBS 148) as they pertain to securitizations.

We continue to believe that best-practice risk measurement must encompass a variety of practices, in order to foster continued evolution of best-practice and in order to provide management with an array of tools to address risks at all points in the economic cycle. Therefore, we agree with the general thrust of the proposed enhancements -- that analysis of the risk of a securitization or re-securitization position, whether held in the banking book or in the trading account, should treat ratings only as a "useful starting point"[2] but that full understanding of the underlying risk (in the asset pool underlying the securitization and in the securitization's legal "waterfall") is a necessity. Other information besides the rating is needed for the investor to utilize this "look-through" approach when making a purchase/sell decision and when allocating appropriate internal capital to any such position or portfolio of securitization positions. In this regard, we wish to support efforts by the American Securitization Forum's Project Re-Start, which would greatly increase the quantity and quality of the information available to the investor in a securitization or re-securitization position.

We also agree with the Consultative Document's view that, other things equal, a re-securitization of a given rating entails more risk than an ordinary securitization of the same rating. Therefore, we agree with the proposed alteration to the Ratings-Based Approach ("RBA") to include columns for re-securitizations that entail higher Pillar 1 capital charges than those for ordinary securitizations.

Additionally, we greatly appreciate the Consultative Document's expression of a "principles-based" approach for the new "operational requirements" for the Pillar 1 capital requirements. These requirements specify that the look-through approach should be used, but the requirements do not limit the investing bank to a specific set of analyses to be carried out utilizing the data on the underlying asset pool for a securitization and on the legal "waterfall." In this manner, the principles-based requirements allow greatest evolution of practices and do not specify practices that may be inappropriate for particular banks given the nature of their business mix or their internal risk measurement and management processes.

The sections of the Document dealing with Pillar 2 determination of the Internal Capital Adequacy Assessment Process ("ICAAP") also employ this principles-based approach, with which we generally

[1] An appendix lists the institutions and staff members that have worked on this response. Not all members participated in this response, and some members may hold views that differ from those put forward in this response.

[2] P. 18, Consultative Document, BCBS 150, January 2009.

agree. In particular, we agree with the following general objectives of Pillar 2, subject to concerns addressed below:

- The need for enterprise-wide risk assessment and management
- The need to identify and assess all forms of risk
- The need to focus especially on the identification, assessment, and management of risk in structured credit products, including securitizations and re-securitizations; and
- The need to incorporate stress tests within ICAAP procedures

II. Concerns

While we agree with these principles and are working even now toward implementing them, we have some significant practical and analytical concerns with regard to the measurement and management of risk in securitization positions.

A. Data flows, MIS, and Analysis within Look-Through Approach. The look-through approach to assessing and managing risk in securitization and re-securitization positions will require new data flows and management-information-systems ("MIS") that currently may not be available to many banks. Historically, only the banks involved in the origination and securitization of the underlying loans (the "sponsors") have tracked individual pool assets and their accompanying risk characteristics (e.g., FICO levels, Loan-to-Value, etc.). Banks that purchase positions in other banks' sponsored securitizations typically have not collected such data.

The new data flows being developed by ASF will involve significant time and money to implement. While we agree with the overall objective of the Basel proposals, it is extremely important for regulators to provide for sufficient time to finalize the data solution. In particular, we believe that requiring such data flows to be implemented as early as year-end 2010 would be premature and may result in inappropriate, inefficient choices being made. We respectfully suggest that a somewhat later deadline be chosen.

Also, the look-through approach should not mandate that all possible pieces of information on the underlying assets be passed through to the investor or that the investor somehow utilize all such data. As the look-through approach becomes mature, in the years following the bottoming out of the credit crisis, more will be known about which explanatory variables are most important, which variables might potentially have use, and which variables are either not useful, or worse, are counter-productive to best-practice risk assessment. It may be most efficient if each Basel country develops a joint industry-regulator process of identifying sufficient, but not burdensome, disclosure of underlying pool data, perhaps in the form of a "summary disclosure format." It would be especially useful if regulators support the growth of such data dissemination by monitoring and reporting on usage of the "summary disclosures" within their markets.

Finally, a critical part of the supervisory reaction to the current crisis will relate to exactly how the investing bank *uses* the new data flows to analyze credit risk of securitization positions and, in the context of ICAAP, allocates internal capital to such positions or portfolios. We wish to repeat that the Consultative Document's principles-based treatment of these analytical possibilities is the right approach to take. No single known risk measurement methodology should be required by regulators or used, to the exclusion of other techniques, by our major banks. All such known risk measurement processes have strengths and weaknesses, and therefore no single process is likely any time soon to evolve into a dominant process for all business lines, all types of risk, and at all times.

B. <u>The use of stress tests</u>. While the Group agrees with the general usefulness of stress tests, we are concerned that regulators may be signaling that ICAAP should be based <u>primarily</u> on stress tests and, in particular, stress tests based on losses occurring during the <u>current crisis</u>. Stress tests are not a panacea for determining appropriate capital allocations. Stress tests are, to some extent, subjective and do not easily lend themselves to capital allocations based on the differing risks of particular positions or particular portfolio constructions. Other risk measurements – ones focused more on risk *differentiation* – should always be used in conjunction with stress tests. Our specific concerns regarding stress tests in the context of securitizations take several forms:

1. <u>Pro-cyclicality</u>. If Basel focuses on using as a stress test the credit losses currently being absorbed, without regard to actual future circumstances, the result would be a capital charge that would act to slow down or abort attempts at a recovery. We believe that Basel should, instead, focus on the Pillar 2 process of ensuring that banks actually adhere to appropriate risk measurement and management processes within all business lines and desks of the financial institution, and at all points in the cycle. Indeed, failures to apply such appropriate risk measurement and management procedures were key causes of the current crisis. Our concern that an excessive stress test could act to choke off recovery is reinforced by discussions regarding stresses that represent even worse loss rates than are currently being observed (such as in the "worse" case stresses applied to large U.S. banking institutions in the context of the U.S. financial bail-out program).

2. <u>Basing stress tests on valuation losses</u>. In any event, stress tests should not be based solely on valuation losses associated with securitization positions – as opposed to intrinsic credit losses realized on underlying asset pools. That is, market perceptions of risk have been shown to be at times unrelated to intrinsic risk measurements and can be driven by market euphoria (during booms) and market pessimism (during busts). Such market valuation losses could be especially onerous when increased by some multiple (as is proposed for stressed VaR tests) or in order to guard against even further valuation declines.

3. <u>Capital being viewed as the only way to meet specific stress tests</u>. It is important for supervisors to keep in mind that the ICAAP process, in the context of stress tests, should NOT be one in which the bank conducts a series of stress tests across many business lines and many risk types, then simply adds up the resulting "capital charges" to determine appropriate internal capital.

   Holding capital now against a future risk in a particular business line is only one of the ways in which the best-practice bank protects against its risks. Appropriate alternative strategies include selling positions in other areas to reduce overall risk. Indeed, such sales of business are now being used by many banks under fire from the crisis, and these sales are an appropriate alternative to raising new capital when a crisis hits, or holding more capital prior to the advent of a crisis. Another appropriate strategy in lieu of holding more capital is to purchase hedge positions (while appropriately holding capital against the counter-party credit risk and basis risk that might be associated with such hedges). Finally, an appropriate increase in credit spreads to accompany newly originated positions during non-crisis periods can bolster retained earnings, over time – earnings that can then be used to absorb losses during a crisis. Above all, we repeat that bank capital management strategies should not be excessively driven by the existence of the current systemic events, lest the recovery itself be endangered.

4. Stress processes should be careful to pay at least some attention to cross-risk-type and cross-business line diversification. Even in the current historically-unprecedented crisis, not all business lines or risk-type-categories are exhibiting significantly more than expected losses. Banks should take at least some comfort in the ability of product and geographic diversification to reduce capital charges below those that might apply to undiversified financial businesses.

C. The market risk and specific risk requirements within the trading account. As we read the proposals within BCBS 148 ("Revisions to the Basel II market risk framework"), in conjunction with the consultative document on incremental risk (BCBS 149), it is apparently the case that rated securitization positions, including AAA-rated positions, held in the trading account by the Advanced IRB bank, would be subject to a Pillar 1 capital requirement equal to the sum of 3 components:

- The bank's 10-day VaR estimate times 3 to 4.
- A new 10-day Stressed VaR estimate times 3 to 4.
- An additional charge calculated according to the standardized (ratings-based) method.

We note that this charge clearly would be much higher than if the rated asset were held in the banking book. Such banking-book versus trading-account comparisons are not a major issue for many best-practice institutions that focus on the quality of the risk measurement. However, while we agree that a simple VaR measurement may be too low for an appropriate capital charge for such an asset in the trading account, we also are concerned that a stressed VaR measurement, depending on how the stress is defined, may be too high, even in the current crisis in which there is still significant uncertainty regarding the ultimate credit losses that may prevail. This stressed VaR charge may be especially onerous if, for example, supervisors ask that the individual bank employ a stressed VaR calculation based on extreme negative price movements during the latter part of 2008. Again, we have a concern that, while stress tests of any sort, including stressed VaR measurements, are useful, relying on stresses based on price declines exhibited during this systemic event could unnecessarily act in a highly pro-cyclical manner, perhaps choking off the needed recovery.

D. Grand-fathering /phase-in. Because of the high cost and difficult timing of implementing the look-through approach to securitization risk assessment, and because of the tenuous capital positions that now exist at many of the global Advanced financial institutions, we respectfully suggest that Basel should act to minimize the effect of the new rules on the planned economic recovery. While we agree that significantly higher capital, over the long run, should generally be required for securitization positions, we note that the current degree of losses in the wake of the bubble would have been much lower -- because the bubble would have been much smaller or non-existent -- if such long-run higher capital requirements had been in place to begin with. In other words, significantly higher capital requirements than those currently required under Pillar 1 could achieve the same effect (reducing the chances of another bubble) as the *even higher* capital requirements associated with current loss rates.

E. Several specific alternatives should be considered to reduce the potential for a highly pro-cyclical impact of the new proposals:

   1. For many large banks, highly rated senior positions of ordinary securitizations are held in the banking book and are not marked-to-market. For these institutions, it is simply not practical to apply a look-through approach for such current positions. However, the proposals call for a very dramatic "cliff effect" associated with failure to apply the look-through approach – the Pillar 1 capital requirement for a AAA-rated position goes from 0.56% to 100% if a look-through approach is not used. It would be very helpful to have a lower than 100%, but still punitive, capital requirement for such senior, ordinary, highly-rated securitization positions (even if the charge is several times that of the current Pillar 1 charge). This would permit such banks to continue to hold the highly rated positions through their remaining lives, during which time there is only a small likelihood of minor credit losses.

   2. Consider grand-fathering any new highly-rated securitization positions that are aimed specifically at implementing recovery efforts. For example, in the U.S., any newly issued highly-rated positions that may otherwise qualify for securitization treatment might either be exempted from securitization treatment or might be permitted to utilize the ratings-based approach absent a look-through approach during the expected lives of the instruments.

   3. Phasing in the new rules, in addition to the suggestions above, might help to avoid choking off the recovery, while still allowing the look-through approach to work over the longer run. One such phase-in might be related to the rating of the securitization if it is an ordinary securitization, not a re-securitization. For example, all AAA-rated ordinary securitization positions might be sheltered from the look-through approach, if the position is not part of a re-securitization transaction, for a period of the next x years. Meanwhile, lower rated or re-securitization positions would be subject to the look-through approach much sooner.

   Still other transition rules might convey the spirit of the new proposals while allowing for critical time to pass while a recovery is realized and new data flows and analysis are implemented

F. <u>Definition of re-securitization</u>.

   1. Re-securitization treatment should not be invoked when an immaterial portion of the underlying assets include a securitization tranche. Such an exception might be limited to cases in which the securitization position is a small percentage of the pool assets or does not have likely high correlation with performance of other pool assets.

2 Re-securitization status should not be required for transactions in which the economic substance is that of an ordinary securitization -- e.g., if the underlying consists of a single securitization tranche coupled with an interest rate swap. In this particular example, the structured liabilities issued by the Trust should receive a rating that would be based on the underlying asset pool, coupled with the prior credit protection inherent in the single tranche associated with that pool. The economic effect is the same as if the underlying assets *were* the pool of loans and there was some additional amount of first dollar protection (associated with the credit enhancement for the tranche-asset) available to the Trust's structured securities.

Alternatively, for a Trust whose assets consist of the single tranche plus rate swap, and which issues only one class of security, that security would receive a rating that is at least as high as the rating on the single tranche-asset (and indeed would be higher due to the protection of the interest rate swap).

G. Definition of ordinary securitization. Covered Bonds should be explicitly defined as not securitizations or should be explicitly exempt from the look-through approach. First, such bonds typically are not structured. Second, the issuance of covered bonds may be necessary for banks and GSEs to recover, and potential investors should not be discouraged by invoking the look-through approach for banks that hold these instruments.

H. Additional concerns with regard to stress tests. As indicated above, we support generally the use of stress tests as discussed in the Pillar 2 Guidance section of BCBS 150. This support extends particularly to Paragraph 78, which calls for stress testing to be an integral part of the overall governance and risk management culture of the institution. We do have specific concerns with Paragraphs 82 and 83, however, which could be interpreted to call for various kinds of "double-counting" of stresses dealing with "reputational" risk. We understand that specific recent events have highlighted regulators' concerns, including:

- The buying back of assets underlying sponsored securitizations, such as was done with SIVs when funds to purchase ABCP dried up for such securitizations. We note that in this particular kind of transaction, the sponsoring bank can protect against "liquidity risk" through the appropriate development of secured and unsecured lines of credit. Moreover, the credit risk associated with such buy-backs may already have been factored into the ICAAP analysis by, in the most conservative case, holding internal capital for the pool of securitized assets as if they had not been securitized. In this example, an additional capital charge associated with an additional "stress" for "reputational" risk would be quite unnecessary.

- Purchasing rated paper in a sponsored securitization. The capital charges under Pillar 1 for such occurrences are clearly spelled out in the section found on pp. 3-4 of BCBS 150 -- the bank must treat the rated position as if it were unrated. If a bank should find itself having to make such purchases in order to protect against "reputation risk", it may already have allocated sufficient capital for such an event if, for example, the bank conservatively allocated, for internal capital purposes, an amount associated with the credit risk of the underlying assets as if they had not been securitized. Again, an additional capital charge for so-called "reputational" risk could be a form of double counting.

- Finally, in no case should the capital charge for ICAAP purposes for all of the bank's positions on a specific bank-sponsored transaction add up to more than the capital charge for the entire underlying asset pool as if the credits had not been securitized (and any gain-on-sale not realized for capital purposes). This treatment would mirror the current treatment of securitization capital charges for Pillar 1 purposes.

I. Pillar 3 (Disclosure) issues. In general, the Group agrees with the objectives of this section of the Consultative Document. The revision to Paragraph 809 of the Framework is broadly consistent with accounting and legal requirements in the U.S., and our Group's members strive to meet the spirit of this paragraph.

Specific concerns include the following:

1. Qualitative disclosures in Table 9:

   a. Part (a) under Qualitative. The final rule should make clear that the accounting treatment of a securitization (whether treated as a sale) is unrelated to a conservative treatment in which capital for ICAAP purposes is measured as if the sale had not taken place.

   b. Part (a) under Qualitative: The new fifth bullet point seems to indicate that banks should disclose specific counterparties, which may be inconsistent with legal confidentiality requirements.

   c. Part (e) under Qualitative: The new fifth bullet point suggests that the bank must disclose specific information flowing from proprietary internal models aimed at determining statistically significant variables used to structure credit enhancements. While a general discussion of process might be useful to investors, disclosure of specific empirical findings could be harmful to the bank's competitive position.

2. Quantitative disclosures in Table 9:

   a. Part (h) under Quantitative (Banking Book): The Committee might allow a bank to fulfill this disclosure requirement by using the same impaired/past due distinctions as its home country agrees are acceptable for satisfaction of the look-through requirement. Such a clause would greatly reduce the burden of cross-country differences in the manner in which the look-through approach is implemented.

   b. Part (h): Banks should be permitted, for disclosure purposes, to utilize their internal quantitative systems that are set up based on the consolidated entity whose equity and debt are publicly traded. This would not lessen the burden of computing internal capital requirements for each legal entity, as required by Basel, but would significantly reduce the burden of the Pillar 3 requirements. Moreover, there would be no loss of benefit to investors, since such stakeholders are interested generally only in the public company's financial condition.

Appendix

RMA Capital Working Group Institutions Participating in the Preparation and/or Review of this Response[3]

Bank of America: John Walter, Senior Vice President, Risk Capital & Portfolio Analysis.
Capital One: Corey D. Sesin, Director, Corporate Treasury.
Citigroup: Fenton Aylmer, Director, Basel II Risk and Regulatory Oversight.
HSBC/North America Holdings: Mary Ann Hageman, First Vice President, Credit Risk Management.
KeyCorp: Robert Kula, Executive Vice President; Robert Levy, Vice President.
M&T: Rajas M. Gokhale, Senior Risk Analyst.
PNC Financial Services Group: Janis L. Tucker, Vice President.
Union Bank of California: Hans Helbekkmo, Senior Vice President, Enterprise Wide Risk; Desta Gebre-Medhin-Huff, Vice President, Basel II Commercial Credit and Basel II Program Support.
Wells Fargo: James Petersohn, Senior Vice President, Corporate Credit; Gary Wilhite, Senior Vice President.
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[3] Individual institutions in the Capital Working Group may have opinions that differ from those expressed in this Response and, as well, individual institutions may be responding to the Consultative Document separately from this Response.