February 7, 2012

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Secretary
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551
Docket No. R-1401
RIN 7100-AD61

Office of the Comptroller of the Currency
250 E Street, S.W.
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Docket ID OCC-2010-0003
RIN 1557-AC99

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
Attention: Comments/Legal ESS
RIN 3064-AD70

Re: Risk-Based Capital Guidelines: Market Risk; Alternatives to Credit Ratings for Debt and Securitization Positions

Ladies and Gentlemen:

The Clearing House Association L.L.C. ("**The Clearing House**"), the American Bankers Association ("**ABA**"), the American Securitization Forum ("**ASF**"), the Financial Services Roundtable ("**The Roundtable**"), the International Swaps and Derivatives Association, Inc. ("**ISDA**") and the Securities Industry and Financial Markets Association ("**SIFMA**" and, together with The Clearing House, the ABA, ASF, The Roundtable and ISDA, the "**Associations**")[1] are writing to comment on the joint notice of proposed rulemaking[2] (the "**NPR**" and, the proposed rule set forth therein, the "**Proposed Rule**") issued by the Board of Governors of the Federal Reserve System (the "**Board**"), the Federal Deposit Insurance

[1] The Associations collectively represent financial institutions accounting for a substantial majority of banking and financial assets in the United States. Please see *Annex A* for a more detailed description of the Associations.

[2] 76 Fed. Reg. 79380 (Dec. 21,2011).

Corporation (the "**FDIC**") and the Office of the Comptroller of the Currency (the "**OCC**", and together with the Board and FDIC, the "Agencies") to incorporate into their proposed market risk capital rules (the "**Proposed MRC Rules**")[3] alternative methodologies for calculating specific risk capital requirements for debt and securitization positions that do not rely on credit ratings.

Part I of this letter summarizes our overarching concerns with the Proposed Rule. Parts II and III of this letter address in additional detail our concerns with respect to the Proposed Rule's methodologies applicable to exposures other than securitizations and to securitizations, respectively, and set forth our thoughts on alternatives to those methodologies; Part IV addresses substantive concerns with the treatment of correlation trading positions under the Proposed Rule as well as the Proposed MRC Rules; and Part V addresses other concerns with respect to the Proposed Rule. Part VI sets forth a list of certain of the Agencies' questions from the NPR and cross references our responses in this letter.

I. Introduction and Summary

The Proposed Rule is being adopted in accordance with the requirements of Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**"). As noted in our comment letters on the Proposed MRC Rules,[4] we continue to believe that, notwithstanding the perceived inadequacies in the issuance and use of credit ratings that contributed to the financial crisis, Section 939A's requirement for a complete abandonment of ratings is both ill advised and an over-reaction.[5] We appreciate the challenges facing the Agencies in their efforts to responding to Section 939A's mandate. Moreover, we generally agree with the standards for alternatives to credit ratings outlined in Part I.C of the NPR – namely, that the alternatives, to the extent possible, should (i) appropriately distinguish the credit risk associated with a particular exposure within an asset class, (ii) be sufficiently transparent, unbiased and replicable, (iii) provide for timely and accurate measurements of negative and positive changes in creditworthiness, (iv) minimize opportunities for regulatory capital arbitrage, (v) be reasonably simple to implement and (vi) foster prudent risk management. We also think it is extremely important that the alternative methodologies not significantly diverge from Basel II.5[6] in a way that sacrifices risk sensitivity or competitively disadvantages U.S. banking organizations *vis-à-vis* their international competitors.

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3 76 Fed. Reg. 1890 (Jan. 11, 2011) (proposed revisions to market risk capital rules).

4 *See* letter, from The Clearing House, the ABA, ISDA and SIFMA, dated April 11, 2011, to the Agencies (commenting on the Proposed MRC Rules) (the "**April 11th Letter**"); and letter, from The Roundtable, dated May 5, 2011, to the Agencies (commenting on the Proposed MRC Rules).

5 The Basel Committee on Banking Supervision (the "**BCBS**") appears to be moving toward an expanded (as opposed to a more limited) use of ratings. *See, e.g.*, *Basel Committee Considers Use of Credit Ratings and LCR Shake-Up* (Risk Magazine, Jan. 26, 2012) (reporting that the BCBS is considering using credit ratings as a factor for determining which sovereign bonds may be treated as highly liquid assets under Basel III's liquidity coverage ratio). The international community's expanded use of risk weightings will only exacerbate the problems posed by Section 939A for U.S. banks.

6 "**Basel II.5**" as used in this letter refers to the Basel Committee on Banking Supervision's (the "**BCBS**") framework for the assessment of capital charges for exposure to market risk, as revised in the following

Nevertheless, the Associations have significant concerns with a number of aspects of the Proposed Rule's alternative methodologies for determining specific risk-weighting factors. In many cases, we believe that the Agencies' objectives set forth in Part I.C of the NPR have not been optimally achieved by various aspects of the Proposed Rule – for example:

- the Proposed Rule's failure to appropriately distinguish the credit risk associated with particular exposures within an asset class (particularly securitizations, resulting from the rather blunt approach of the simplified supervisory formula approach ("**SSFA**"), which would substantially overstate the amount of capital required for certain securitization exposures);

- the underlying biases in the Organization for Economic Cooperation and Development's ("**OECD**") Country Risk Classification (used in establishing risk-weighting factors for sovereign debt exposures and debt positions of depository institutions, foreign banks and credit unions (collectively, "**banking entities**") and public sector entities ("**PSEs**"));

- the Proposed Rule's failure to accurately measure negative and positive changes in creditworthiness (as a result of, in the case of corporate debt, the three proposed metrics in general and the leverage indicator in particular, and, in the case of securitizations, the determination of K_G, K_{SSFA} and the ratio of cumulative losses to K_G and related issues); and

- implicit incentives that are contrary to prudent risk management (*e.g.*, the general failure of the Country Risk Classification approach to sovereign debt to establish higher risk weight factors for instruments with greater risk and the SSFA's general risk insensitivity, in each case, creating perverse incentives, if capital costs were the only consideration, for banks to purchase higher-risk and higher-yielding sovereign debt and securitization positions).

More generally, in our view, the Proposed Rule's methodologies have important shortcomings, including that:

- they are not sufficiently risk sensitive, and therefore represent a step back from the more risk sensitive approach of Basel II.5. This concern is heightened by the Agencies' stated intention to revise the general risk-based capital rules applicable to positions held in the banking book by incorporating creditworthiness standards similar to those in the Proposed Rule;

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publications: BCBS, *Enhancements to the Basel II Framework* (July 2009), available at http://www.bis.org/publ/bcbs157.pdf; BCBS, *Revisions to the Basel II Market Risk Framework* (July 2009), available at http://www.bis.org/publ/bcbs158.pdf; BCBS, *Guidelines for Computing Capital for Incremental Risk in the Trading Book* (July 2009), available at http://www.bis.org/publ/bcbs159.pdf; and BCBS, *Changes to the Revisions to the Basel II Market Risk Framework* (June 2010), available at http://www.bis.org/press/p100618/annex.pdf.

- with respect to securitizations, they (i) discourage banks from underwriting, purchasing, making a market in or engaging in secondary trading in less risky securitization positions and (ii) result in negative effects on the availability and liquidity of credit to American consumers and businesses that will have significant adverse effects on the recovery of the U.S. economy;

- they lead to different and, in some cases, more punitive risk weights than under Basel II.5's ratings-based approach and therefore could very well disadvantage U.S. banking organizations *vis-à-vis* their international competitors;

- they could require capital charges in excess of dollar-for-dollar capital for some institutions; and

- in certain cases, they are pro-cyclical.

In addition, the Associations have serious concerns regarding the appropriateness of using the SSFA in determining the capital requirements for correlation trading positions under the CRM as well as several aspects of the Proposed MRC Rules' treatment of correlation trading positions, including the imposition of the 15% surcharge under the CRM, the lack of an explicit cap on maximum losses and the failure of standard charges to properly measure the overall risk of the correlation trading portfolio.

The capital markets play a critical role in providing credit to the United States and global economy by bringing together issuers and investors. By doing so, capital markets increase the availability of credit to the economy and reduce over-concentrated reliance on banks to finance the economy. Banking organizations' securities underwriting, secondary trading and market-making activities are at the core of functioning capital markets. The Proposed Rule will have a direct effect on companies' ability to access the capital markets by virtue of the central role banking organizations serve in bringing issuers and investors together and providing liquidity to investors. Investors require banking organizations to be committed to trade a security in order to be comfortable to buy that security at new issuance. Issuers require banking organizations to underwrite and sell a security to investors. If the Agencies' market risk capital rules are not risk-sensitive and create uneconomic incentives for holding or not holding securities, they risk materially altering, and potentially harming, the systemic liquidity that allows issuers and investors to transact in the capital markets.

In light of our concerns, we have set forth in this letter our initial thoughts as to more appropriate, risk sensitive alternatives to the methodologies set forth in the Proposed Rule, to the extent feasible given the comment deadline. We would be delighted to work with the Agencies on an on-going basis to flesh out these proposals after the submission of this letter and join with the Agencies in developing solutions where they have deficiencies.

Our principal objective in developing alternatives to the Proposed Rule's methodologies for sovereign debt, bank, financial entity and corporate debt positions and securitizations is not to achieve lower overall capital requirements than what would otherwise be required under the Proposed Rule, but rather to increase risk sensitivity and to minimize potential competitive inequities relative to non-U.S. institutions. Indeed, the Associations' preferred alternative path for certain debt positions likely would increase the specific risk capital requirement for some exposures (*e.g.*, certain OECD

sovereign debt exposures).[7] Furthermore, in developing these alternatives, we seek to promote transparency and to develop methodologies that banking organizations of varying sizes and levels of operational sophistication could effectively and efficiently utilize, consistent with the standards enumerated in Part I.C of the NPR.

Finally, we respectfully submit that the Agencies should not implement the final rule until potential alternative methodologies can be developed in detail and thoroughly considered and a quantitative impact study has been undertaken to determine the comparability of the Proposed Rule's alternative methodologies to Basel II.5's ratings-based approach as well as to assess the impact of the Proposed Rule on banking organizations, the availability and cost of credit and the U.S. economy. After potential alternatives have been more fully developed and a QIS has been undertaken, we urge the Agencies to re-publish the Proposed Rule for further comment.

II. Concerns with the Proposed Rule's Treatment of Non-Securitization Exposures

A. Sovereign Exposures

i. The CRC methodology has deficiencies and limitations that disqualify it as a credible approach.

Under the Proposed Rule, the specific risk-weighting factors of sovereign debt positions are to be determined based on the sovereign's classification under the OECD's Country Risk Classification (the "**CRC methodology**").[8] The CRC methodology is also used under the Proposed Rule to determine the specific risk-weighting factors of debt positions of banking entities and PSEs. The CRC methodology consists of a quantitative assessment pursuant to the Country Risk Assessment Model ("**CRAM**") used to assess country credit risk and a qualitative assessment of the CRAM results by country risk experts from OECD members through which the CRC methodology integrates political risks and other risk factors not taken into account in the CRAM.

The Associations believe that the Proposed Rule's CRC methodology is problematic. First, there are significant potential conflicts of interest in the CRC process because OECD member countries are effectively assigning their own ratings. Replacing the judgment of third party credit rating agencies concerning sovereign debt, whatever their perceived shortcomings, with decisions made by functionaries of the very governments whose credit they are supposed to rate potentially raises more questions than are solved by the requirements of Section 939A of Dodd-Frank.

Second, the CRC methodology measures "country risk", which generally correlates with, but is not equivalent to, sovereign credit risk. For purposes of the CRC, "country risk" consists of

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[7] Attached as *Annex B* is a comparison of capital requirements under the Proposed Rule and under Basel II.5's risk-based approach for sovereign debt exposures and investment grade corporate debt positions. See, in particular, page 1 of *Annex B*, setting forth comparisons for sovereign debt. A more risk-sensitive approach will almost certainly result in higher capital requirements than those required by the Proposed Rule's methodology for many countries.

[8] The CRC methodology is used for transactions covered by the OECD arrangement on export credits to determine the premium interest rate charged to cover the risk of non-repayment of export credits.

"transfer and convertibility" risk (*i.e.*, the risk that a sovereign imposes capital or exchange controls preventing an entity from converting local currency into foreign currency or transferring funds to creditors outside that country) and cases of force majeure (*e.g.*, war and natural disasters).[9] Indeed, as the OECD itself states, "[t]he country risk classifications are not sovereign risk classifications and should not, therefore, be compared with the sovereign risk classifications of private credit rating agencies."[10] While "country risk" as measured by the CRC does bear some relationship to general economic conditions in a particular country and therefore appears to have a correlation with sovereign debt risk at some level, this correlation may be somewhat attenuated and therefore supplementing the CRC methodology with additional factors, as described below, is clearly warranted.

Third, as acknowledged in the NPR, the CRC ratings process has little transparency.[11] Ratings are assigned following a determination of CRAM results and meetings of country risk experts. These meetings and details of the CRAM are confidential however, and no official reports of the deliberations at the meetings are made publicly available.[12] The general lack of transparency makes the CRC classification process a "black box" from the perspective of banking organizations, thereby making capital planning more difficult and capital requirements less predictable.

Fourth, the CRC lacks risk sensitivity in practice. OECD members defined as "high-income countries" by the World Bank receive a CRC of zero, even if a country has recently experienced significant financial and budgetary distress and has actually had to request international aid because it was likely unable to pay its sovereign debts as they became due. For example, Portugal currently has a CRC rating of "0" and therefore its sovereign obligations would receive a risk weighing of zero for purposes of the CRC methodology despite the fact that Portugal is rated "B" or "below investment grade" for purposes of Basel II.5's ratings-based approach (and thus receives a specific risk-weighting factor of 8%). The NPR has attempted to somewhat alleviate this type of concern by applying the highest specific risk-weighting factor (12%) to the debt positions of sovereigns that have "defaulted" on any exposure during the previous five years. However, this adjustment does little to address the overall risk insensitivity of the Proposed Rule given the small number of countries likely to experience an actual "default" for purpose of the Proposed Rule and the fact that this higher risk weight would only be applied after the fact of a default. More concretely, this element of the Proposed Rule would correctly assign a high risk weighing to Greece if and when it were to "default" (albeit broadly defined), but we note that Greece currently has a CRC rating of zero and therefore its debt, which under any standard is objectively quite risky, would have the same capital charge today under the Proposed Rule as the sovereign debt of Norway.

Finally, the capital requirements under the CRC methodology would differ from those under Basel II.5's ratings-based approach in many instances, particularly for sovereigns that are OECD

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9 *See* OECD, *Country Risk Classification*, http://www.oecd.org/document/49/0,2340,en_2649_34171_1901105_1_1_1_1,00.html (Jan. 2012).

10 *See Id.*

11 *See* 76 Fed. Reg. 79380, 79384.

12 *See* OECD, *Country Risk Classification*, http://www.oecd.org/document/49/0,2340,en_2649_34171_1901105_1_1_1_1,00.html (Jan. 2012).

members.[13] In this instance, however, the CRC methodology results in more favorable capital treatment for OECD sovereigns than under the Basel II.5 ratings-based approach.[14] Although it is possible to view this result as a beneficial side effect of the Proposed Rule, we believe it is symptomatic of the limitations of the CRC methodology and the fact that it can lead to this counterintuitive result in a world in which the sovereign debt of certain OECD countries, particularly in Europe, is broadly viewed by the market to be *more* rather than less risky. The Proposed Rule therefore may create a perverse incentive, absent other factors, to hold certain sovereign debt and other instruments that receive high marks under the CRC methodology as opposed to other asset classes that may indeed be objectively less risky.

ii. Sovereign debt exposures should be addressed using a more risk-sensitive approach that addresses the deficiencies of the CRC methodology.

The Associations urge the Agencies to replace the CRC methodology with a more risk-sensitive approach that does not suffer from conflicts of interest and is transparent. It is vital that any alternative approach to the CRC methodology be properly aligned with international standards for the capital treatment of sovereign exposures so as not to disadvantage U.S. banks.

We acknowledge and appreciate that, in the NPR, the Agencies have set forth two market-based alternatives as supplements to or replacements for the CRC methodology. As the Agencies undoubtedly recognize from their own deliberations in preparing the NPR, developing such suitable risk sensitive market-based alternatives that do not lead to competitive inequalities *vis-à-vis* non-U.S. institutions is time consuming and fraught with analytical complexity and practical difficulties. Given the short allotted comment period for the NPR, we have not had an effective opportunity to either fully analyze the proposed credit default swap and relative bond-spread alternatives in the NPR or fully develop one or more other suitable alternatives to the CRC methodology. As such, we hope to be able to work together with the Agencies in a cooperative manner with respect to these particular issues after the submission of this letter.

iii. Certain sovereign debt exposures funded with local currency assets should continue to be assigned a lower specific risk-weighting factor.

The Associations strongly support the Proposed Rule's notion that a banking organization should be permitted to assign a sovereign debt position a specific risk-weighting factor that is lower than the applicable specific risk-weighting factor otherwise assignable to that position if it is

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13 *See* page 1 of *Annex B*.

14 *Annex B* contains the Associations' analysis of the treatment of certain sovereign debt exposures under Basel II.5's risk-based approach and the Proposed Rule. This analysis shows that the specific risk weighting factors of a number of OECD member sovereign debt exposures were significantly lower under the Proposed Rule than they were under Basel II.5's risk-based approach. Seventeen of the 36 exposures of sovereigns with a CRC of zero or one received lower risk weightings under the Proposed Rule (namely, zero) than they did under Basel II.5, under which their risk weightings varied between 20% and 150%. The exposures of the other 19 countries remained the same. In contrast, the CRC methodology resulted in a higher risk weighting for all but one of 48 countries with a CRC of 7 (specifically, increasing their respective risk weightings from 100% under Basel II.5 to 150% under the Proposed Rule). See page 1 of *Annex B*.

denominated in the sovereign entity's currency, the banking organization has at least an equivalent amount of liabilities in that currency and the sovereign entity allows banking organizations under its jurisdiction to assign the lower specific risk-weighting factor to the same position. We believe that this aspect of the Proposed Rule promotes sound risk management practices by encouraging banking organizations to fund local currency assets with local currency liabilities, a much safer practice than funding those assets with foreign liabilities.

B. Exposures to Government Sponsored Entities ("GSEs")

i. Exposures to GSEs should receive a specific risk-weighting factor of zero to the extent the exposure is backed by the full faith and credit of the United States.

The Proposed Rule defines a GSE to include any entity established or chartered by the U.S. government to serve public purposes specified by the U.S. Congress, but the obligations of which are not explicitly guaranteed by the full faith and credit of the United States. The NPR provides that the specific risk-weighting factors for GSE debt exposures would vary from 0.25 to 1.6%, based on maturity.[15] The Associations urge the Agencies, in the final rule, to treat debt exposures of GSEs that are explicitly backed by the full faith and credit of the United States the same as sovereign debt positions backed by the full faith and credit of the United States. To the extent the U.S. government has provided an explicit guarantee of a GSE debt exposure, there is no reason to believe that a default on that exposure is more likely than any other debt issued directly by the United States. In addition, we urge the Agencies to treat the debt positions of Fannie Mae and Freddie Mac as having received an explicit guarantee from the U.S. government in light of the government conservatorships of Fannie Mae and Freddie Mac and the financing agreements put in place by the U.S. Department of the Treasury to ensure that these GSEs continue to meet their obligations to the holders of bonds that they issued or guaranteed. Should the government's relationship to Fannie Mae and Freddie Mac change, we would expect the treatment of their debt positions to change accordingly (*e.g.*, in the event of the sale of one of the GSEs' assets and liabilities to a private acquirer, treating its debt obligations as corporate debt positions).

C. Debt Positions of Banking Entities

i. The CDS spread methodology for assigning specific risk-weighting factors to corporate debt positions described in Part II.E should also be used to assign specific-risk weighting factors to the debt positions of banking entities.

Under the Proposed Rule, debt positions of banking entities would be assigned specific risk-weighting factors between 0.25% and 12% based on (i) the CRC of the sovereign entity in which the banking entity is incorporated and (ii) in certain instances, the residual term of the debt position. Although determining specific risk-weighting factors based on the credit risk of a sovereign may be sensible for PSE debt positions (discussed below), we do not believe that this approach is sensible for

[15] We note that, although the preamble indicates that the specific risk-weighting factors of GSE debt exposures will vary from 0.25 to 1.6% based on the remaining maturity of the position, the Proposed Rule provides that banking organizations must assign a 1.6% specific risk-weighting factor to a debt position that is an exposure to a GSE. Proposed Rule, § 10(b)(2)(iii). It does not provide that the specific risk-weighting factor should vary based on remaining maturity.

debt positions of banking entities. The credit risk of individual banking entities can vary widely across the banking sector in a particular country and banks can, and often do, fail without any intervention from home country regulators. As such, we do not believe that a methodology that equates sovereign risk and banking entity risk is analytically justified. Moreover, such an approach is risk insensitive – contrary to the NPR's stated goals – and is inconsistent with Basel II.5, irrespective of the use of credit ratings.

Although there are differences between the balance sheet compositions of banking entities and non-bank corporate obligors, we do not believe that these differences warrant the use of fundamentally different methodologies for determining the capital treatment of banking entity debt positions and corporate debt positions. After all, credit risk is credit risk, regardless of whether the institution in question makes widgets or loans. Accordingly, we urge the Agencies to apply the CDS spread methodology described in broad outline in Part II.E below for the reasons described in that Part, including increased risk sensitivity and decreased pro-cyclicality. In the event that the information necessary to apply the CDS spread methodology is unavailable, asset swap or bond spreads could be used as a proxy for CDS spreads. In the event that no reliable spread information[16] is available, the Proposed Rule's indicator-based methodology could be used, although the indicators would need to be recalibrated to account for differences in the balance sheet composition of banking entities and non-banking entities and to ensure that the capital requirements of the indicator-based methodology were generally comparable to those under Basel II.5's ratings-based approach. For example, the calibration of the leverage ratio would need to be adjusted because banking entities generally are more leveraged than nonbanking entities with comparable credit profiles. As with sovereign debt positions, we would be happy to work further with the Agencies to develop a CDS spread methodology for banking entity debt positions and modifying the Proposed Rule's indicator-based methodology so that it could be applied to banking entity debt positions when no reliable spread information is available.

D. Debt Positions of PSEs

i. A market-based approach should be used in place of the CRC methodology in assigning specific risk-weighting factors to debt positions of PSEs.

We generally agree with the Proposed Rule's approach of closely aligning the specific risk-weighting factors of debt positions of PSEs with those of the PSEs' home country. The likelihood of government support of these debt positions and general correlations among the credit risks posed by PSEs and their home countries supports this approach. However, our concerns with the CRC methodology as used for sovereign debt exposures, discussed in Part II.A, apply equally to its use for debt positions in PSEs. Accordingly, the Associations urge the Agencies to work with us to develop suitable risk sensitive market-based alternatives to the CRC methodology that do not lead to competitive inequalities *vis-à-vis* non-U.S. institutions.

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[16] We would be happy to work with the Agencies to define what constitutes "reliable spread information" for these purposes.

E. Corporate Debt Positions

i. As proposed, the indicator-based methodology for calculating the specific risk weighting factor for non-financial corporate debt positions is seriously flawed.

The NPR proposes an "indicator-based methodology" for assigning specific risk-weighting factors to corporate debt positions that are exposures to publicly traded, non-"financial institutions".[17] The Proposed Rule's indicator-based methodology consists of three indicators: (i) leverage, measured by the ratio of total liabilities to the market value of assets of the applicable public company, (ii) cash flow, measured as the ratio of earnings before interest expense, taxes, depreciation and amortization to a market value of assets and (iii) stock price volatility, measured as the standard deviation of the corporate obligor's monthly stock price as of the last trading day of each month over the immediate preceding 12 months.

Although the Associations generally commend the Proposed Rule's use of market data in assigning specific risk-weighting factors to non-financial corporate debt positions, the indicator-based methodology has several serious flaws, including:

1. The methodology's indicators and the calibrations of those indicators are extremely risk insensitive. As a consequence of this risk insensitivity, banking organizations have little incentive to hold high quality corporate debt instruments and the Proposed Rule's treatment of non-financial corporate debt positions differs significantly from the treatment of these positions under Basel II.5's ratings-based approach.

The excessively conservative calibration of the indicators (especially the leverage indicator), and the indicators themselves (which in our view are not generally indicative of credit risk, either alone or when considered together), cause the Proposed Rule's approach to be highly risk insensitive and results in unfavorable capital treatment for many highly-rated (and high-quality) debt positions as a general matter and as compared with the capital treatment of these positions under Basel II.5's ratings-based approach. The Associations analyzed the treatment of corporate debt under the Proposed Rule's indicator-based methodology for corporate debt positions.[18] The debt sample analyzed consisted of the investment grade corporate debt of the 125 issuers referenced in the CDX.IG.15 index. The debt obligations of 113 of these issuers would receive a higher risk weighting under the Proposed Rule (100%) than they would under Basel II.5's ratings-based approach (20%).[19] The capital treatment of the debt obligations of the other 12 issuers did not change. None of these debt obligations – even those

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[17] As an alternative to this indicator-based methodology, a banking organization would be given the option of assigning a flat 8% specific risk-weighting factor to all of its corporate debt positions.

[18] More detailed information regarding the treatment of investment grade obligations under the Proposed Rule and Basel II.5's ratings-based approach is contained on page 2 of *Annex B*.

[19] The same result is obtained when comparing the capital treatment of these obligations under Basel I and the Proposed Rule – the investment grade debt obligations of 113 of the 125 issuers would receive a worse capital treatment under the Proposed Rule (100% risk weighting) than they do under Basel I (20% risk weighting).

rated AA and AAA – received a risk weighting other than 100% under the Proposed Rule's indicator-based methodology. The Associations' analysis revealed that the indicator-based methodology fails to distinguish even between BB-rated and AAA-rated debt obligations, assigning each a 100% risk weighting (based on an 8% specific risk-weighting factor). Moreover, based on the Associations' analysis, it would appear that even some high yield corporate obligations rated as low as C would receive the same risk-weighting factor (*i.e.*, 8%) as the corporate debt obligations rated AA and AAA in the debt sample used by the Associations. As a consequence of its risk insensitivity, the indicator-based methodology would appear to fail both to measure relatively wide ranging positive and negative changes in creditworthiness and to distinguish appropriately the credit risk associated with investment grade corporate debt positions, contrary to the standards for ratings alternatives outlined in Part I.C of the NPR.

Our analysis found that the main driver of the foregoing results was the excessively conservative calibration of the leverage indicator, which causes the indicator-based methodology to be insufficiently risk sensitive, assigning the same specific risk weighting factor to corporate debt positions with widely different credit profiles (*e.g.*, as noted, a AAA-rated and C-rated debt obligation receive the same risk weighting). In most cases, the reason investment grade obligations received a specific risk-weighting factor of 8% was a leverage indicator score in excess of 0.2.

Moreover, as a general matter, the leverage indicator values will vary widely across industries and can give a misleading picture of the credit quality of a company. For example, utilities generally have high debt-to-asset ratios but the spreads of their corporate debt instruments generally reflect the markets' perception of their generally low credit risk.

Regardless of whether one believes that ratings were a deficient tool for evaluating credit risk in the period leading up to the financial crisis, a methodology the results of which are so at odds with third-party credit ratings is highly dubious at best. The purpose of Basel II.5 and the U.S. market risk rules is to properly match capital requirements with actual risk on a proportionate basis. A methodology that, as per our analysis, results in all of the investment grade corporate debt of issuers in the CDX.IG.15 index receiving a 100% risk weighting achieves almost no risk sensitivity and therefore does not meet the Proposed Rule's stated goals to "[a]ppropriately distinguish credit risk associated with a particular exposure within an asset class" and to "[p]rovide for the timely and accurate measure of negative and positive changes in creditworthiness".[20]

We recognize that the Agencies have sought to develop methodologies that result in "generally" the same risk weightings and related capital requirements as under Basel II.5's ratings-based approach. However, although in some limited instances the Proposed Rule's methodologies would result in potentially more favorable treatment than under Basel II.5,[21] our analysis indicates that the aggregate impact of the Proposed Rule will be to increase capital requirements for impacted corporate debt positions relative to Basel II.5's ratings-based approach.

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[20] 76 Fed. Reg. 79382.

[21] For example, a limited number of high yield corporate debt positions could receive more favorable capital treatment under the Proposed Rule.

The consequences of the risk-insensitivity of the Proposed Rule's approach, largely resulting from the leverage indicator, are potentially serious. If capital requirements were the only consideration, the methodology would cause banking organizations to have the perverse incentive to acquire objectively riskier corporate debt obligations with a higher yield instead of acquiring lower-yielding debt obligations of AAA rated issuers.[22] Contrary to the apparent intention of the Proposed Rule in calibrating the leverage indicator, the Proposed Rule's conservatism in the leverage component may actually undermine the safety and soundness of banking organizations in practice. Moreover, the Proposed Rule would place U.S. banking institutions at a significant competitive disadvantage *vis-à-vis* their foreign peers subject to the more risk sensitive market risk requirements under Basel II.5's risk-based approach. In addition, because the Agencies have indicated that methodologies similar to the Proposed Rule's methodologies will be incorporated into the general risk based capital requirements in the future and those capital requirements will serve as the risk-based capital floor pursuant to Section 171 of Dodd-Frank, any competitive imbalances and perverse incentives are likely to be amplified for the U.S. banking industry more broadly.

2. The Proposed Rule's indicator-based methodology is pro-cyclical.

Because the stock volatility and leverage indicators will tend to increase, and the EBITDA indicator will tend to decrease, during economic downturns, capital requirements under the Proposed Rule's methodology for public non-financial corporate debt positions will also tend to increase during economic downturns. Conversely, during periods of economic growth, the stock volatility and leverage indicators will tend to decrease and the EBITDA indicator will tend to increase, resulting in decreasing capital requirements under the Proposed Rule's methodology. As a consequence, the Proposed Rule's indicator-based methodology is pro-cyclical; it will contribute to a contraction in the supply of credit during economic distress, potentially prolonging the economic distress, and will contribute to an expansion in the supply of credit during periods of economic growth, potentially exacerbating credit bubbles.

3. The indicators used in the Proposed Rule's methodology are backward-looking and do not take into account detailed debt characteristics.

The indicators used in the Proposed Rule's methodology are blunt financial measures that overlook many important factors in assessing creditworthiness. The indicators tend to be "backward looking" and only utilize historical financial information. In contrast, and as acknowledged by the Agencies in the NPR, an approach based on the market price of credit protection on a company's debt, for instance, would take into account information regarding the company's future prospects, and thus potentially be more risk-sensitive. Further, these indicators do not take into account detailed debt characteristics that bear on the credit risks of a given corporate debt position, such as seniority and term

[22] We note that the Proposed Rule's proposed assignment of a specific risk-weighting factor of 8% to the corporate debt positions of non-banking entity financial institutions is, for obvious reasons, completely risk-insensitive and, similar to the Proposed Rule's indicator-based methodology for non-financial corporate debt positions, would provide banking organizations with a strong incentive to acquire high yield corporate debt positions of such financial institutions that generally would under both the indicator-based methodology (if such positions were non-financial corporate debt positions) and Basel II.5's ratings based approach receive a specific risk-weighting factor of 12%.

structure. Because of the Proposed Rule's indicators' backward-looking nature and their failure to account for more detailed debt characteristics, there is a substantial risk that the Proposed Rule's indicator-based methodology will overstate or understate the credit risk of a corporate debt instrument, as the case may be.[23]

ii. The Proposed Rule's indicator-based methodology should be replaced with a forward-looking market-based methodology based on relative CDS spreads. If the CDS data necessary to apply the Associations' methodology is not available, asset swap or bond spreads could be used as a proxy for CDS spreads. In the event that no reliable spread information is available, a recalibrated version of the Proposed Rule's indicator-based approach could be used.

The punitive aspect of the indicator-based methodology could, in theory, be mitigated by recalibrating the thresholds that define the specific risk-weighting factor buckets (*e.g.*, a doubling of the leverage indicator threshold and the stock price volatility threshold would cause a more reasonable percentage of investment grade corporate debt positions to be treated as such under the indicator-based methodology). However, these changes do not address the pro-cyclicality of the methodology or the general risk insensitivity of the indicators. Nor would a recalibration solve issues related to the cross-industry variation of indicator values that do not reflect credit quality, or the fact that the indicator-based methodology will be cumbersome to implement and monitor. To address these issues, the Associations urge the Agencies to use a modified version of the NPR's bond-spread approach based on relative CDS spreads in place of the Proposed Rule's indicator-based methodology. If the CDS data necessary to apply the Associations' methodology is not available, asset swap or bond spreads could be used as a proxy for CDS spreads. Although imperfect, in the event that no reliable spread information is available, a recalibrated version of the Proposed Rule's indicator-based approach could be used.

The NPR discussed, as an alternative to the indicator-based methodology, a bond-spread based approach that would assign both financial and nonfinancial corporate debt positions to general categories of "high risk", "medium risk" or "low risk" depending on whether the particular position is priced above or below certain market-based thresholds. The NPR proposed comparing the one-year average of the spreads of a financial institution's closest to five-year senior unsecured bond, to the one-year averages of two credit default swap indices, such as the five-year CDX.NA.IG.FIN index and the five year CDX.NA.HY.B. For non-financial companies, the one-year average spreads of corporate debt positions could be compared to the one-year averages of the CDX.NA.IG and CDX.NA.HY.B. The specific risk-weighting factor of a corporate debt position would then be assigned based on the spread of the corporate debt position relative to the relevant indices.

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[23] In view of the deficiencies of the Proposed Rule's indicator-based methodology, we submit that the costs banking organizations would incur in implementing the systems necessary to calculate capital requirements in accordance with this methodology would not be justified.

Although we agree with the general bond-spread approach laid out in the NPR, we believe the NPR's bond-spread approach has the following deficiencies:

- It would be substantially misaligned with Basel II.5's risk-based approach. By defining low risk corporate debt positions as those with a one-year average bond-spread less than that of CDX.IG index the approach immediately treats a significant portion of investment grade corporate debt positions as non-investment grade.[24] As a consequence, it is inherently more punitive than Basel II.5's risk-based approach.

- As noted in the NPR, bond spreads can reflect factors other than credit risk. These factors include, among others, a bond's coupon, maturity, funding and liquidity.

- Not all companies have an actively traded five-year debt instrument or CDS.

- Although the use of one-year average spread should in principle improve the stability of classifications, the NPR's bond-spread approach was significantly less stable than the Associations expected, possibly because of the instability of the boundaries between the three categories (*i.e.*, "high risk", "medium risk" and "low risk") as the spread between CDX.IG and CDX.HY varies.[25]

- Although we agree that, in principle, the use of a relative market-based spread should reduce pro-cyclicality, the NPR's bond-spread methodology was significantly more pro-cyclical than the Associations expected (again likely because of the instability commented on above).

- Two corporate debt positions with the same CDS spread may receive different specific risk-weighting factors. For example, a financial corporate debt position may be treated as "low risk" simply because CDX.NA.IG.FIN is wider than CDS.NA.IG.

At least some of these deficiencies in the NPR's bond-spread approach could be addressed if modified as follows:

- The bond-spread approach should not use separate indices for financial and non-financial entities. Two corporate debt obligations with the same CDS spread should have the same risk classification under the bond-spread methodology. The bond-spread methodology could compare the spread to just one CDX.IG index.

- Consistent with the general risk-based capital rules, we propose that corporate debt positions be divided into two, as opposed to three, categories, with investment grade corporate obligations receiving an up to 1.6% risk-weighting factor and non-

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[24] See Figure 1 of *Annex C* for a graph showing the percentage of certain investment grade corporate debt positions that would not be categorized as "low risk" under the Agencies' bond-spread methodology.

[25] See the lines labeled as "NPR High Risk", "NPR Medium Risk" and "NPR Low Risk" in Figure 3 of *Annex C*, illustrating the volatility of classifications under the Agencies' bond-spread methodology.

investment grade corporate obligations receiving an 8% risk-weighting factor, pursuant to an indicator score tied to a relative spread.

- A relative spread could be defined, for example, as: (Average End of Month CDS Spread Over 12 Months) / (Average End of Month CDX.NA.IG Spread Over 12 Months). If this ratio is less than two, then the corporate debt obligation would be classified as investment grade and, if equal to or greater than two, it would be classified as non-investment grade.

Under this simplified approach, a more reasonable number of current investment grade names would be treated as investment grade, as illustrated in Figure 2 of *Annex C*.[26] As a consequence, the misalignment of the Proposed Rule's bond-spread approach with Basel II.5's risk-based approach would be reduced. This approach also yields a more stable classification than the NPR's bond-spread approach.[27] We note that this approach would also be more risk sensitive than Basel II.5's risk-based approach and significantly more risk-sensitive than the Proposed Rule's indicator-based methodology.

As noted above, when the CDS data necessary to apply the Associations' spread approach is available, that approach would be applied. For debt positions without actively traded CDS, asset swap or bond spreads could be used as a proxy for CDS spreads. In the event that no reliable spread information is available, a recalibrated version of the Proposed Rule's indicator-based approach could be used.

Again, we hope to be able to work together with the Agencies in a cooperative manner to more fully develop the details of our layered approach to debt positions of corporate issuers and banking entities.

F. The Proposed Rule's Alternative Methodologies

i. The Proposed Rule's investment grade alternative methodology for determining the specific risk-weighting factors of corporate debt positions is not sufficiently risk sensitive and would result in capital requirements that differ sharply from those under Basel II.5's risk-based approach.

Although the investment grade methodology would be simple and easy to implement, it has at least two significant drawbacks. First, the non-investment grade category would likely capture debt positions with a wide range of credit quality. As a consequence, banking organizations would be encouraged to acquire, other things equal, riskier debt securities in order to increase investment

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[26] For example, the percentage of investment grade corporate debt obligations misclassified varies approximately between 7% and 20%, as opposed to approximately between 17 percent and 53% percent under the NPR's bond-spread methodology, in each case, over a six-year period.

[27] *See* Figure 3 of *Annex C*, comparing the lines labeled as "IG Spread" (representing the percentage of DTCC's 1000 most actively traded names, as of January 13, 2012, that would be treated as an investment grade name according to the Associations' proposed relative spread methodology at different points in time) and "IG" (representing the percentage of DTCC's 1000 most actively traded names, as of January 13, 2012, that were rated investment grade by S&P at different points in time).

returns. Second, this methodology would result in significantly different capital treatment for corporate debt positions from that required under Basel II.5's risk-based approach. For example, under Basel II.5's risk-based approach, debt positions rated investment grade by two nationally recognized credit rating services with residual terms to maturity exceeding 24 months would receive a 1.6% specific risk-weighting factor – significantly less than the 6% specific risk-weighting factor such positions would receive under the investment grade methodology (assuming they were "investment grade" securities for purposes of the OCC's investment securities regulations). As a result of this difference in capital treatment, U.S. banking organizations may be competitively disadvantaged. Accordingly, the Associations urge the Agencies not to adopt the investment grade methodology.

III. Concerns with the Proposed Rule's Treatment of Securitization Exposures

Consistent with the previous comment letter of the American Securitization Forum ("**ASF**") regarding the advance notice of proposed rulemaking regarding alternatives to the use of credit ratings in the risk-based capital guidelines,[28] the Associations are of the view that the following "guiding principles" for credit ratings alternatives, which the Associations believe are well-aligned with the Agencies' policy objectives set forth in Part I.C of the NPR, should be embodied in any alternative creditworthiness standards for securitization exposures. Any alternative should:

- promote understanding by banking organizations of the risks associated with their securitization exposures;
- focus on (i) actual performance of assets, which is the primary driver of the performance of an asset-backed security ("**ABS**"), and (ii) the credit support available to a given risk position within an ABS structure after factoring in the assets' performance;
- function to facilitate dynamic and timely adjustment of capital in a manner that is consistent with and proportionate to changes in asset performance and the resulting risk profile of a given exposure; and
- be premised on data that are available to all market participants and should otherwise comport with standard market practices so that all participants have the option of performing the necessary calculations.

Although the Associations agree with the Agencies that any alternative should not be overly complex and that results should be replicable across banking organizations, simplicity should not override the factors set forth above.

We believe the Proposed Rule's SSFA methodology fails to optimally address either the Agencies' own objectives set forth in the NPR or the Association's guiding principles with respect to securitizations. More importantly, the SSFA methodology is flawed in various respects as more

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[28] *See* letter from the ASF to the Agencies and the Office of Thrift Supervision, dated October 25, 2010, *available at* http://www.americansecuritization.com/uploadedFiles/ASF_OCC_Legal_Investment_Comment_Letter_10-25-10.pdf.

particularly set forth below. The Associations are therefore proposing modifications to the SSFA and to the SFA that address these flaws and better promote outcomes in line with the NPR's objectives and such guiding principles.

A. General Concerns

i. The SSFA substantially overstates the amount of capital required for certain securitization exposures, and may have several unintended negative consequences, including, among others, reducing the availability of credit, impeding the recovery of the U.S. economy and encouraging banking organizations to hold riskier securitization exposures.

For specific reasons demonstrated in *Annex D*, the SSFA will, in its current form, substantially overstate the amount of capital required for certain securitization exposures for all banking organizations subject to the Proposed Rule, including certain investments in securitizations that finance consumer assets such as credit card and auto receivables and student loans and commercial assets including fleet leases and equipment loans and leases. This overstatement will discourage banking organizations from underwriting, making a market in, or engaging in secondary trading in, such securities, which, in turn, will meaningfully reduce the liquidity of ABS generally. If an approach similar to the Proposed Rule's approach is applied to securitization positions held in the banking book, it will also become less likely that banking organizations will invest in these transactions. When they do, the costs of doing so will increase dramatically. Because banking organizations subject to the Proposed Rule are vital intermediaries and financing sources for these assets, the resulting negative effect on the availability and cost of financing for American consumers and businesses and the market liquidity for securitization exposures will be substantial. This negative effect on the availability and liquidity of credit to American consumers and businesses will have significant adverse effects on the recovery of the U.S. economy.

In addition, if the SSFA is adopted in its current form, (i) as a result of the significant changes in required capital levels that occur when losses are close to the threshold for the steep, next highest risk-weighting factor in the supervisory floor, the incentives banking organizations have to sell securitization positions under such circumstances will be greatly increased, thereby significantly reducing the market liquidity for the affected securities and promoting pro-cyclicality, (ii) banking organizations will be discouraged from underwriting, purchasing, making a market in, or engaging in secondary trading in, even high quality, low-risk securitization positions and (iii) banking organizations will be encouraged to hold riskier securitization positions with greater returns. In our view, none of these outcomes is consistent with what should be the goals of appropriate revisions to the risk-based capital rules.

The Associations note that our comments on the SSFA and our proposed alternative methodology are premised on our understanding, that cumulative losses applied in determining the proposed risk weight floors are in reference to the loss of principal on issued securities[29] in the relevant

[29] As used in this letter, the term "**issued securities**" refers to issued debt securities in a securitization transaction based on our understanding that equity securities were not intended to be included in the use of this term in the Proposed Rule.

transaction as stated in Table 7 of the NPR rather than as a percentage of the securitized asset pool amount. If our understanding is incorrect, there are substantial additional issues with the Proposed Rule that will need to be addressed and will take additional time to analyze. We reserve the right to provide additional comments with respect to issues related to calculating cumulative losses against the securitized asset pool should our understanding prove incorrect.

B. Specific Concerns[30]

i. K_G is a highly risk insensitive measure for calculating the required capital for exposures underlying a securitization position.

By reverting to a Basel I methodology for calculating K_G, the Proposed Rule completely ignores differences in the credit quality of exposures of the same broad category underlying a securitization position. For example, prime auto loans and sub-prime auto loans are assigned the same risk weight under the general risk-based capital rules. As demonstrated by the examples set forth in *Annex D*, this methodology for calculating K_G penalizes banking organizations for investing in higher credit quality transactions with low loss levels and therefore low attachment points. K_G as proposed is also not adjusted upward if the credit performance of a securitized asset pool is materially worse than anticipated, which could understate required capital as compared to a more risk sensitive approach to determining K_G. In our view, therefore, the proposed K_G will not achieve the Agencies' stated objective of adequately capturing the risk of particular exposures.

ii. Determining the risk weight floor based on the ratio of cumulative losses to K_G in the manner contemplated by the Proposed Rule is not an appropriate benchmark of credit quality.

As demonstrated by the examples set forth in *Annex D*, establishing a risk weight floor for securitization positions using this ratio in the form proposed does not give appropriate benefit to transaction structure (*e.g.*, tranching of risk that can change during the life of a transaction based upon trigger mechanisms set forth in the transaction documents). As a result, SSFA as proposed will in certain instances require the same amount of capital to be held against riskier junior securitization positions as against less risky senior securitization positions in the same transaction. If cumulative losses are determined as a percentage of the securitized asset pool rather than the principal of issued securities, this effect would be further exaggerated. This is inconsistent with the stated design of the SSFA. The Agencies state in the NPR that "[t]he SSFA is designed to apply relatively higher capital requirements to the more risky junior tranches of a securitization that are the first to absorb losses and relatively lower requirements to the most senior positions."[31] A lack of granularity in the size of the risk weight floors as losses increase also results in inappropriately large increases in capital requirements for securitization positions that are not justified by the level of performance deterioration exhibited by the underlying securitized exposures.

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30 *Annex D* to this letter sets forth example calculations of capital using the SSFA that illustrate the points in Parts III.F.ii.1 and III.F.ii.2 set forth below.

31 76 Fed. Reg. 79394.

iii. Setting the minimum risk weight floor at 20% currently creates competitive issues for U.S. banking organizations that seek to purchase high credit quality securitization positions.

Foreign banking organizations that are active investors and market makers in the U.S. securitization market use the Basel II-advanced approaches and therefore their investments in very high credit quality securitization positions would attract substantially less capital than the capital that would be required to support the same position if held by a U.S. banking organization. In addition, the establishment of such a high floor eliminates any risk sensitivity in the assessment of capital at the higher end of the credit spectrum. This lack of sensitivity will discourage investment in the highest quality assets in favor of lower-quality, higher yielding assets and, over time, increase pricing on the highest quality assets as the market seeks to compensate for the higher capital requirements.

iv. The carrying value of a securitization position is not taken into account in determining its attachment point for purposes of the SSFA calculation.

Where the carrying value of a securitization position is less than its par value, the credit risk of that position is reduced and the differential between par value and carrying value represents credit enhancement that is available to that position. Unless that credit enhancement is reflected in the attachment point for such position, the capital requirements for such positions will be overstated using the SSFA methodology.

v. Reserve accounts funded from any source should be taken into account in determining the attachment point of a securitization position.

Section 10(b)(2)(vii)(B)(2) of the Proposed Rule permits "reserve accounts funded by the cash flows from the underlying exposures" to be included in determining the attachment point for a securitization position. However, funded reserve accounts from any source provide the same level and quality of credit enhancement to a securitization position and should therefore be included in any such determination.

vi. Use of the SSFA requires substantially more capital on a transaction-wide basis for certain securitization exposures than would be required if the pool assets were not securitized.

The Associations agree with the Agencies that banking organizations should not be permitted to use securitization to engage in capital arbitrage. Banking organizations should also not be substantially penalized from a regulatory capital perspective, however, for the appropriate use of securitization. Doing so would be inconsistent with the premise long held by the Agencies that capital requirements should neither encourage nor discourage securitization. The Associations are therefore of the view that any methodology used for calculating the regulatory capital requirements for securitization exposures of banking organizations should result in total capital requirements for all securitization exposures in the transaction that do not substantially exceed the capital that would apply to the pool assets if they were not securitized. Otherwise, the Proposed Rule will unnecessarily create impediments to prudent securitizations and the funding provided through such securitizations to consumers and businesses.

vii. The 1.5 supervisory calibration parameter for re-securitizations in the Proposed Rule will overstate capital requirements for certain positions that meet the current definition of re-securitization under the Agencies' "advanced approaches" rules.

A re-securitization as currently defined in the Agencies' internal-ratings-based and advanced measurement approaches capital rules[32] includes any securitization position with respect to which any of the underlying exposures is a securitization position. Existing corporate loan securitizations frequently include a relatively small percentage of assets in the form of other corporate loan-backed asset-backed securities in order to help ensure appropriate risk diversification for investors. Such securitization exposures should not be treated as re-securitization exposures for purposes of the SSFA calculation.

viii. The Proposed Rule is not clear as to how capital requirements should be calculated under the SSFA for re-securitization exposures generally.

The Proposed Rule should be modified to provide clear guidance as to how these calculations should be made.

ix. The Proposed MRC Rules do not clearly allow for look-through treatment for mortgage and other asset-backed indices, such as the CMBX and ABX, such that an index can be broken down into its constituent parts for risk-weighting and offsetting purposes.

A failure to permit this look-through treatment would result in an undeservedly punitive capital treatment that does not reflect the nature of the instruments and would be detrimental to market participants' ability to hedge, ultimately raising the cost of credit availability to end users.[33]

C. Given the issues with the SSFA discussed above, the Associations urge the Agencies to make certain modifications to the SSFA to address its deficiencies.

Because of the foregoing deficiencies in the SSFA, we believe it would be generally preferable to use the SFA (with the modifications we propose herein) in place of the SSFA. Given the SFA's superior risk sensitivity, we believe that a banking organization (whether or not approved to use the Basel II advanced approaches) should be able to use a modified version of the SFA that would permit it to be applied to securitization exposures, provided that the banking organization can demonstrate that it has the necessary sophistication and resources to apply the SFA (as modified) and has an appropriate governance structure in place to prevent arbitrage opportunities, as discussed in further detail in Part III.D below.

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[32] *See* 12 C.F.R., part 3, Appendix C (OCC); 12 C.F.R., part 208, Appendix F and 12 C.F.R. part 225, Appendix G (Federal Reserve); 12 C.F.R., part 325, Appendix D (FDIC).

[33] As discussed in Part IV.D, we also believe that this look-through treatment should apply when determining the 8% floor and the standard charge for positions that are part of the correlation trading portfolio but excluded from the CRM.

We recognize, however, that it may not be practical for all banking organizations to utilize the SFA, even with our proposed modifications. We therefore believe there is a place for an alternative methodology, such as the SSFA. Nevertheless, we believe that the SSFA as set forth in the Proposed Rule should be modified to address some of its more important deficiencies so it can serve as a more acceptable alternative where use of the SFA (with our proposed modifications) is not readily achievable.

As such, the Associations propose the following changes to the SSFA.[34]

i. The approach to calculating K_G would consist of (i) specific initial percentages for securitization positions based upon the asset class and in some cases credit quality or underwriting standards applied to the underlying securitized exposures, and (ii) upward adjustments based on the expected losses on seriously delinquent underlying exposures.

The Associations would propose amending the SSFA to align it (and by extension the treatment of securitization exposures) more closely with the current risk-based capital rules with respect to loans. We believe that this alignment can, importantly, be achieved through modification of the currently proposed SSFA formula, rather than the creation of a new formula.

The calculation of risk-based capital for loans is fairly straight-forward and standardized. The capital requirement for loans is used in the proposed SSFA formula in K_G, defined as "the weighted-average capital requirement of the underlying exposures calculated using the agencies' general risk-based capital rules." What we believe K_G is missing or, more specifically, understating, is the fact that banking organizations should be required to reserve for losses against non-performing assets which would make this approach more consistent with overall risk-based capital requirements. A simple correction to the proposed SSFA formula would be to modify K_G to reflect these loan loss provisions in a formulaic fashion.

As an example, prudently underwritten mortgages[35] carry a risk-weight of 50%, or 4% risk-based capital, against those loans. If, however, 10% of the loans in a pool of first lien mortgages are seriously delinquent, a banking organization would be required to hold increased reserves against those seriously delinquent loans in the amount of expected losses against those loans.

In lieu of defining K_G as set forth in the Proposed Rule, the Associations would suggest defining K_G as "(a) the weighted-average capital requirement of the *performing* underlying exposures calculated using Table 1 below, plus (b) the expected losses on seriously delinquent underlying exposures (defined as loans 90 days or greater past due) calculated using historical three-month loss

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34 *Annex E* sets forth illustrations of the application of the SSFA with our proposed modifications and *Annex F* sets forth comparative calculations for capital for securitization positions using SSFA as set forth in the Proposed Rule and SSFA within our proposed modifications.

35 As used in this letter, "**prudently underwritten mortgages**" refers to mortgages entitled to receive a 50% risk weighting under Agencies' general risk-based capital rules.

severities on the underlying exposures if publicly available, or 50%[36] (the "**Loss Severity**")." Formulaically, this would be defined as:

((100% minus the Percent of Seriously Delinquent Loans) * Table 1 Capital Requirement)

plus

(Percent of Seriously Delinquent Loans * the Loss Severity)

Table 1

Asset Type	Loan Capital Requirement
Prudently Underwritten Mortgages	4.0%
Prime Bank Credit Cards	4.0%
Prime Auto Loans	4.0%
Other Low Loss Assets	4.0%
All other	Consistent with General Risk Based Capital Rules

For example, where 10% of the loans in a pool of underlying exposures of prudently underwritten mortgages are seriously delinquent and the Loss Severity is 50%:

K_G = (90% * 4%) + (10% * 50%) = 8.6%

K_G levels for the specific asset classes described above have been derived by members of the Associations from their analysis of the historical performance of these asset classes. This analysis was conducted based on substantial performance data available with respect to these asset classes over extensive time periods and widely varying economic conditions. Members of the Associations would be pleased to provide the Agencies with further detail as to how initial K_G levels were derived for each of these asset classes. The Associations request the ability to provide initial K_G values for additional specific asset classes not currently listed in Table 1 above based on historical loss levels and other data presented to the Agencies justifying such results. Given the time frame to comment on the Proposed Rule, the Associations were unable to analyze the relevant data for other asset classes including, without limitation, equipment loans and leases, fleet leases and SBA loans that may deserve a lower K_G value based upon their historical low loss experience.

[36] For the government guaranteed portion of underlying exposures, the loss severity should be assumed to be zero percent.

ii. We believe that two changes should be made to the attachment point in order to recognize positive difference (if any) between the par value and carrying value of a securitization position and cash reserve funds funded from any source.

In order for the SSFA's attachment point to better reflect the underlying characteristics (and thus the credit risk) of a securitization position, two changes should be made.

First, the attachment point should recognize the discount from par at which a securitization position is held. Carrying value is an exceedingly important factor in the amount of risk-based capital a bank must hold against a security. Specifically, a notable discount to par for a particular position is typically indicative of a security that has either been previously written-down (*e.g.*, through Other Than Temporary Impairment) or a security that has been purchased in the secondary market, where the markets are highly proficient at pricing for risk. The discount to par for a particular position provides additional protection to the holding value of the position to any potential exposure to writedowns on the pool of underlying assets. Therefore, it is clear that a security held at par carries more risk to the banking organization holding the position than the same security being held at a discount to par. As such, carrying value must be included in the calculation of risk-based capital in the proposed SSFA formula. Reflecting carrying value in the proposed SSFA formula can be done by modifying the calculation of Parameter A, or the attachment point of the position, to reflect an increase in the attachment point by the absolute percentage of the discount from par on the thickness of the security (thickness being defined as the detachment point of the position less the attachment point of the position).

Second, cash reserve funds funded from any source should be taken into account in determining the attachment point for a securitization position. It is our understanding that, under the Proposed Rule, cash funded reserve funds subordinated to a banking organization's securitization position funded from any source should be reflected in available credit enhancement for purposes of determining the attachment point of a securitization position. Section 10(b)(2)(vii)(B)(2) of the Proposed Rule, however, limits the inclusion of cash funded reserve funds for these purposes to those that are funded from accumulated cash flows from the underlying exposures. The Associations are proposing modifications of Section 10(b)(2)(vii)(B)(2) that provide that cash funded reserve funds funded from any source may be included in calculating the attachment point of a securitization position.

More particularly, in order to address the foregoing proposed changes, Parameter A should be defined as (i) the attachment point of the position, defined as a percentage equal to (a) the dollar amount of the securitization positions that are subordinated to the position (including all forms of hard enhancement, such as overcollateralization, cash reserve accounts, letters of credit, etc.), divided by (b) the dollar amount of the entire pool of underlying assets, plus (ii) (a) the discount from par at which the position is held, expressed as a percentage, multiplied by (b) the detachment point of the position less the attachment point of the position. The detachment point of a position should be defined as a percentage equal to (a) the attachment point of the position plus (b) (i) the dollar amount of the positions and all *pari passu* positions with respect to loss allocation, divided by (ii) the dollar amount of the entire pool of underlying assets.

iii. A risk weight floor would be (i) equal to the single minimum risk weight floor applicable to securitization positions under the Basel II advanced approaches

as in effect from time to time, or (ii) if the Agencies determine to retain the concept of a dynamic risk weight floor, calculated using a more granular risk weight floor table that takes into account the capital and credit enhancement at the tranche level of a securitization position that is available to absorb cumulative losses.

In the NPR, Table 7 sets forth the "Supervisory Minimum Specific Risk-weighting Factor Floors for Securitization Exposures", as follows:

Cumulative Losses of Principal on Originally Issued Securities as a Percent of K_G at Origination		Specific Risk-weighting Factor (in percent)
Greater than:	Less than or equal to:	
0	50	1.6
50	100	8.0
100	150	52.0
150	n/a	100.0

Because deterioration of the credit quality of a securitized asset pool would under our modifications be reflected in a higher K_G and thus a higher capital level under the SSFA calculation, the Associations suggest that the only appropriate capital floor is the minimum risk weight factor for securitization positions set forth in the Basel II advanced approaches as the same may be modified from time to time (currently 0.56%). As discussed above, the Associations view the SSFA with our modifications as more than sufficient to reflect the increased risks with respect to securitizations that suffer losses in addition to losses the transactions would have been expected to suffer (and therefore would be reflected in the initial K_G calculation for the securitization position). The Agencies only goal in establishing a floor, therefore, should be to assure a level of competitive equality with international banking organizations, which calibrating a risk weight floor to the Basel II minimum risk weight floor achieves.

If the Agencies nevertheless view a dynamic capital floor as necessary, the Associations believe that Table 7 should be revised as set forth below. As discussed above, the lack of granularity in the size of the risk weight floors in the proposed SSFA Table 7 as losses increase results in inappropriately large increases in capital requirements for securitization positions that are not justified by the level of performance deterioration exhibited by such securitization positions. Our proposed changes to Table 7 would make any applicable risk weight floor more granular. Our proposed methodology for calculating a dynamic risk weight floor would also address the significant issue that the SSFA as proposed will in certain instances require the same amount of capital to be held against riskier junior securitization positions as against less risky senior securitization positions in the same transaction.

The risk weight floor would adjust under our proposal based upon the cumulative losses on the originally issued securities (consistent with Table 7 in the NPR) and changes in the credit enhancement of the relevant securitization position over time.[37] The changes in credit enhancement

[37] We note that the issued securities with respect to certain securitization positions would not be subject to cumulative losses (*i.e.,* non-write down structures) as that term is defined in the Proposed Regulations. We would suggest that the definition of cumulative losses in the final rule be modified to include implied write downs on issued securities to ensure a more conservative and accurate measure.

would be incorporated by comparing the losses on the originally issued securities to the sum of (i) K_G at origination and (ii) Parameter A (with our suggested changes) at the time of calculation. This inclusion of credit enhancement allows the comparison of experienced losses on the securities not only to the original capital charge of the underlying exposures, but also to the structural protection of the securitization position, which would make Table 7 more risk-sensitive by differentiating between different tranches of a securitization trust. The floor will increase as the credit quality of the credit pool decreases, and will correspondingly decrease as the issued securities have less exposure to losses.

CLP as a percent of (K_{GI} plus A)		Specific Risk-weighting Factor (in percent)
Greater than or equal to:	Less than:	
0	25	0.56
25	30	0.64
30	40	0.80
40	50	1.60
50	60	2.80
60	70	4.00
70	85	6.00
85	100	8.00
100	115	20.00
115	130	34.00
130	150	52.00
150	n/a	100.00

Where:

CLP = cumulative losses of principal on originally issued securities as a percentage of the original principal amount of such securities

K_{GI} = K_G at origination of the relevant securitization exposure (expressed as a percentage)

A = Parameter A (expressed as a percentage) of the securitization position at the time of calculation

iv. A risk weight ceiling for senior securitization positions equal to the K_G (with our proposed modifications) of such positions would be applied.

The Associations believe that the specific risk-weighting factor (both floor and formula) of the most senior tranche of a securitization should be capped at the adjusted K_G (as outlined in Part III.C.i). With respect to a re-securitization position, we would ask that the cap apply for purposes of determining the risk weight floor of such positions. For these purposes, a senior tranche should be defined as one that has a detachment point of 100% at the time of calculation. This treatment will ensure that the most senior tranche of a securitization, which by definition has a less risky profile than the underlying pool in the aggregate, is not subject to a higher risk weight than would be assigned to the underlying loans if they were held on the balance sheet of the banking organization.

v. The Proposed Rule would be clarified to provide a subordinate securitization position for purposes of calculating the attachment point for a more senior securitization position is a securitization position that absorbs losses prior to such senior position.

The Associations believe it would be useful to clarify what constitutes a subordinated position for purposes of the Proposed Rule. The Associations recommend that a position be defined as a "subordinate position" to some other securitization position to the extent that position absorbs losses prior to the other securitization position.

vi. Re-securitization positions for purposes of applying the supervisory calibration parameter ("P") would be redefined as securitization positions where more than 10% of the underlying positions are securitization positions, and certain aspects of the treatment of re-securitization positions should be clarified in the final rule.

As discussed above, a re-securitization position as currently defined in the Agencies' capital rules includes any securitization position with respect to which any of the underlying exposures is a securitization position. Existing corporate loan securitizations frequently include a relatively small percentage of assets in the form of other corporate loan-backed asset-backed securities. Such securitization exposures should not be treated as re-securitization exposures for purposes of the SSFA calculation. The Associations therefore propose that a re-securitization position be redefined as securitization positions where more than 10% of the underlying positions are securitization positions.

It is also unclear how the SSFA should be applied to re-securitization positions. We understand that required capital should be calculated for each underlying securitization position by running the SSFA calculation for such position and applying the risk weight floor to such position. K_G for the re-securitization position would be a weighted average of the underlying securitization position required capital based on the principal balances of those positions. Cumulative losses for the re-securitization position would be losses on the issued securities in the re-securitization transaction itself. Cumulative losses on the underlying securities are taken into account in calculating the capital for such underlying position, which is in turn used to calculate the K_G for such position as described above. The Associations would suggest that the final rule contain specific guidance to this effect.

vii. Tranche-specific interest only positions would incur capital charges on the same basis as principal positions within the same tranche.

It is our understanding that interest only positions that receive payments based on a pro rata portion of a securitized asset pool would not be securitization positions under the Proposed Rule. In contrast, interest only positions tied to a specific tranche within a securitization trust would be considered a securitization position. The final rule should clarify that these tranche-specific interest only positions incur capital charges on the same basis as principal positions within the same tranche.

D. Any banking organization that demonstrates to the appropriate Agency that it has the necessary resources and sophistication to calculate the SFA should be permitted to use a modified version of the SFA to calculate capital for a securitization position in

the trading book or banking book, provided that the banking organization has the appropriate monitoring and governance to prevent potential arbitrage opportunities.

Because the SFA relies on inputs for calculating capital for securitization positions that are based upon the performance of the securitized assets underlying the relevant securitization position, it provides a far more accurate capital calculation than the SSFA, even with our proposed modifications. The use of the SFA to calculate capital for securitization positions in the trading book would promote consistent capital calculations as between a banking organization's trading and banking books. It would also be the approach that is most similar to the modified Basel II guidelines and therefore would best promote international alignment of capital standards.

Thus, we believe that banking organizations, whether or not they qualify to use the Basel II advanced approaches, should be permitted to use the SFA to calculate the capital requirements for securitization positions for purposes of both the trading book and the banking book if they demonstrate to the appropriate Agency that they have the necessary resources and sophistication to calculate the SFA, as well as a governance structure to prevent arbitrage opportunities.[38] Use of the SFA should be subject to appropriate supervisory review and approval.

As the Agencies point out in the NPR, however, the SFA was designed for use by banking organizations that originated the exposures being securitized. The SFA therefore needs to be modified if it is to be available for use by banking organizations investing in securitization exposures with respect to securitized assets that they did not originate. The Associations therefore propose the following changes to the SFA.[39]

i. Banking organizations would be permitted to use pool-wide determinations of PD and LGD for all securitized wholesale and retail exposures.

As the Agencies acknowledge, banking organizations investing in such securitization exposures do not in many circumstances have the information available to calculate the PDs and LGDs of individual wholesale exposures and segments of retail exposures as required by the current Basel II advanced approaches for purposes of calculating K_{IRB}. The Associations therefore propose that investing banking organizations be permitted to use information available at the asset pool level in order to determine PD and LGD for purposes of calculating the required capital on a securitization exposure in circumstances where the more specific inputs required by the current version of SFA are not available. As the ASF Alternative Ratings Taskforce has previously proposed, these pool-wide inputs could be updated quarterly in order to increase the risk sensitivity of the approach, as suggested by the Agencies in the NPR.

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[38] As discussed in Part IV.A, we believe that banking organizations should be able to apply the SFA when computing the 8% floor and 15% surcharge on correlation trading positions under the CRM as well as when calculating the risk weighting of other positions that are part of the correlation trading portfolio but are excluded from the CRM.

[39] Attached as *Annex G* to this letter are the specific changes the Associations would recommend to the existing SFA and accompanying regulatory guidance in order to implement the changes the Associations are proposing below.

ii. The modified SFA would require the quarterly re-calculation of SFA inputs if a pool-wide approach is used.

In order to permit the pool-wide calculation of PD and LGD for securitized wholesale and retail exposures, the Associations are proposing a new definition of "eligible securitized exposure" that is based on the definition of "eligible wholesale exposure" in the Basel II advanced approaches without the one year limit on tenor imposed by such definition. It would limit the ability to assign pool-wide PD and LGD inputs to exposures (i) that the banking organization did not directly or indirectly originate or (ii) if originated by the banking organization or related securitization special purpose entity ("**SPE**"), are (x) not serviced by either such person, or (y) are securitization exposures for which the banking organization is prohibited by law or regulation from accessing the information necessary to determine the risk parameters required to calculate K_{IRB} for the underlying individual securitized wholesale exposures or segments of securitized retail exposures. Consistent with the definition of eligible wholesale exposure, our proposed definition would also require that the exposure be generated on an arm's-length basis, provide the banking organization or securitization SPE with a pro rata claim on proceeds and not constitute a concentrated exposure in order to qualify for the pool-wide calculations the Associations are proposing.

iii. Banking organizations could use a conservative proxy for an LGD of less than 100% where LGD cannot otherwise be determined for a securitized asset pool if the appropriate Agency had pre-approved lower LGD assumptions for the asset class and obligor category for the banking organization's general use.

The current SFA would require an LGD of 100% for assets for which an expected credit loss (but not a PD) can be estimated. This is an overly conservative assumption for assets that have proven over time to result in significant recoveries following default. The Associations would therefore propose that the SFA be modified to permit banking organizations to use LGD assumptions of less than 100% if the appropriate Agency has approved such an LGD assumption for the particular asset class and obligor type for use generally by the banking organization in calculating capital under the Basel II advanced approaches.

iv. The use of conservative market proxies for PD and LGD for asset pools that have experienced low defaults and/or low loss experiences would be specifically permitted.

The current SFA contains no guidance as to how to assign PD and LGD to assets with low historical defaults or losses. The Associations are proposing that guidance be added that indicates that banking organizations should assign conservative market proxies approved by the appropriate Agency for PD and LGD for such asset pools.

v. Positive difference (if any) between the par value and carrying value of a securitization position would be taken into account with respect to the SFA calculation for the securitization position.

The SFA should also take into account any positive difference between the par value and carrying value of a securitization exposure as additional credit enhancement ("**L**") for purposes of the SFA calculation. Such carrying value differential provides additional protection to the holder of a

securitization position. Because losses on the underlying assets would be absorbed by this difference before the banking organization would take further write downs (losses) on its position, it needs to be included in L for that term to reflect all credit enhancement. The Associations note in this regard that the Agencies include in L the discount in the purchase price for the underlying securitized receivables. Since the two discounts have the same economic effect, the Associations see no basis for distinguishing between the two discounts in computing L. A corresponding adjustment should also be made to the thickness of the relevant position ("**T**").

vi. Banking organizations could include as additional credit enhancement additional amounts not represented by subordinate securitization positions determined using cash flow methodology approved by the appropriate Agency.

Finally, as the Agencies also point out in the NPR, the SFA in its current form does not recognize additional credit enhancement available to a securitization position from cash flows on securitized assets. The inability to recognize such cash flows can substantially understate credit enhancement for securitizations such as credit card and auto loan securitizations. As the Agencies acknowledge, this will create competitive issues for U.S. banking organizations in comparison to foreign banking organizations that use the Basel II.5 ratings-based approach, because both of these approaches would allow the recognition of the impact of excess cash flows on the creditworthiness of a securitization position.

In order to assure the integrity of such cash flow calculations, the Associations propose that excess cash flows only be permitted to be taken into account as additional credit enhancement in the SFA calculation in determining the values of L and the amount of the underlying exposures ("**UE**") to the extent that:

- the banking organization has received prior approval from the relevant banking agency to do so. Such approval would be conditioned on the banking organization's demonstrating that it has a comprehensive understanding of risk characteristics of its individual securitization exposures and the risk characteristics of the pools underlying its securitization exposures;

- the banking organization can access all relevant performance information on the underlying pools on an on-going basis in a timely manner. For resecuritizations, the banking organization must have information not only on the underlying securitization tranches, such as the issuer name and credit quality, but also on the characteristics and performance of the pools underlying the securitization tranches;

- the banking organization has a thorough understanding of all structural features of the relevant securitization transaction that would materially impact the performance of the bank's securitization exposure;

- the cash flow methodology used by the banking organization is (i) commercially available, (ii) transparent and verifiable and (iii) used by the banking organization for purposes other than the calculation of risk-based capital requirements, such as risk management or impairment analysis; and

- the additional cash flow credit enhancement for a securitization exposure is based on a projection of the available cash flows for the benefit of such securitization exposure determined by undertaking specific steps that are consistent with industry best practices.

E. The Association's proposed modifications to the Proposed Rule's treatment of securitization positions are consistent with the Association's guiding principles.

We believe that our proposed modifications to the Proposed Rule's treatment of securitization positions are consistent with our guiding principles set forth in Part III.

- Both our proposed Revised SSFA and our proposed modified SFA promote understanding by banking organizations of the risks associated with their securitization exposures. Under the Revised SSFA banking organizations will need to constantly monitor the credit enhancement levels of their securitization positions and the delinquency experience of the exposures underlying their securitization positions. The modified SFA requires banking organizations to keep apprised of the risk metrics that affect their securitization positions and encourages them to constantly monitor the effects that changing cash flow characteristics of the asset pools underlying these positions have on the credit quality of these positions.

- Both our proposed Revised SSFA and our proposed modified SFA focus on (i) actual performance of assets, which is the primary driver of the performance of an ABS, and (ii) the credit support available to a given risk position within an ABS structure after factoring in the assets' performance. Under the Revised SSFA, initial capital levels are set based on the historical loss experience of the securitization exposure and the credit quality and/or level of underwriting of the relevant asset class of the underlying exposures and required capital changes is a function of the performance of the underlying asset pool and changes in credit enhancement levels. Specifically, K_G takes into account non-performing assets in our proposal, which makes the SSFA formula more risk sensitive because it now will take into account asset deterioration or improvement. In addition, we have added Parameter A into the floor calculation to give credit to the available credit support for a given risk position to make the floor calculation more relevant to the structure of the ABS. Our proposed modified SFA similarly takes into account these factors in the computation of required capital.

- As a consequence of these features, both of our proposed methods for calculating capital on trading book positions function to facilitate dynamic and timely adjustment of capital in a manner that is consistent with and proportionate to changes in asset performance and the resulting risk profile of a given exposure.

- Finally, both of our proposed approaches are premised on data that are available to all market participants and otherwise comport with standard market practices so that all participants have the option of performing the necessary calculations. With our proposed changes, the information necessary to calculate capital requirements under both the Revised SSFA and the modified SFA is readily available from or can

be derived from servicer reports for securitization transactions or publicly available sources.

We believe that it is important for the Agencies to provide banking organizations with the ability both to use the Revised SSFA and, if they meet the requisite qualifications to do so, the SFA with our proposed modifications. Although we believe the Revised SSFA addresses many of the concerns with the SSFA as set forth in the Proposed Rule, the SFA with our modifications in our view is a better approach for calculating capital given its increased risk sensitivity and that its calculation is based on the specific characteristics of the exposures underlying the securitization position for which capital is being calculated. The Revised SSFA provides a reasonable alternative that produces reasonable capital outcomes for banking organizations that do not qualify to use the modified SFA.

F. Look-through treatment for mortgage and other asset-backed indices should be permitted, such that an index can be broken down into its constituent parts for risk-weighting and offsetting purposes.

The Associations believe it is critical that the final rule allow for look-through treatment for mortgage and other asset-backed indices, such as the CMBX and ABX, such that an index can be broken down into its constituent parts for risk-weighting and offsetting purposes.[40] We believe this is the appropriate approach to the treatment of indices because the aggregate cash flows of the individual constituents of the index are exactly the same as those of the index itself. A number of market participants use these indices to hedge their residential and commercial mortgage exposures. An undeservedly punitive capital treatment that does not reflect the nature of the instruments would be detrimental to market participants' ability to hedge, ultimately raising the cost of credit availability to end users.

Under a look-through approach, the risk-weights would be based on the individual constituents of the index instead of the index itself. In addition, the individual constituents would be allowed to offset against single name positions to the extent there was a match on the underlying names and other criteria are met. For securitization positions that do not correspond to constituents of an index, the Agencies should further provide for offsetting credit for any hedge obtained for such positions based on the relevant index. Banking organizations should not be punished for taking reasonable steps to hedge their securitization positions where perfect hedges are not available. The Associations believe that this approach better reflects the economic risk of the positions and aligns the regulatory capital calculation to the actual creditworthiness of the index, which is based on its individual constituents, while also providing the regulatory incentive to hedge and prudently risk-manage a banking organization's securitization portfolio.

In addition to the issues above on index look-through, further clarity is required as to how this framework is intended to apply to derivatives, and how the Proposed Rule interacts with the Proposed MRC Rules and the other aspects of the Agencies' capital rules. In particular, how should the

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[40] As discussed in Part IV.D we also believe that look-through should be permitted when determining the 8% floor and the standard charge for positions that are part of the correlation trading portfolio but excluded from the CRM. In addition, see Part IV.D for a discussion of the differences between a "look-through" approach and decomposition.

market value of effective notional be defined in the market risk capital calculations for securitization derivative positions? Also, as discussed in Part IV.C, we believe that the capital requirement should be capped at the maximum loss that the banking organization can suffer on long and short positions, notwithstanding the floor, and we would request that the Agencies confirm this treatment.

G. Alternatives to the SSFA

The Associations have also considered the alternatives to the SSFA discussed by the Agencies in the NPR. For the reasons set forth below the Associations do not view any of these alternatives, other than the use of the SFA as discussed above, as viable replacements or alternatives to the Revised SSFA.

i. A concentration ratio is an overly simplistic and risk insensitive methodology.

The concentration ratio poses many of the same issues as do the SSFA and accompanying risk weight floor without our proposed modifications. A concentration ratio ignores the positive effects of asset overcollateralization that is not in the form of an issued securitization position on the risk inherent on the positions that benefit from the same. It is insensitive to the risks inherent in the securitized exposures, and therefore does not meet the Agencies' policy objectives of appropriately distinguishing credit risk exposures within asset classes, providing for timely and accurate measurements of credit quality, and fostering prudent risk management.

ii. A credit spread based measure is not preferable to an analytical assessment of creditworthiness.

For securitization positions, the Associations support the proposal to use an analytical assessment of creditworthiness, such as our proposed Revised SSFA and modified SFA, rather than credit spread based measures. Unlike wholesale markets where issuer default risk is the key driver of credit spreads, a securitization position's underlying asset type and structural features are also key drivers of each issued security's risk profile. Different tranches of securities issued by a securitization will likely have different levels of liquidity (*e.g.*, thick, senior tranches are generally much more liquid than thin, non-senior tranches), making it difficult to isolate credit risk for each tranche in a credit spread based approach. In addition, for a given seniority level, credit spreads may also vary materially by asset type across securitizations. Furthermore, applying an analytical assessment for trading book positions is consistent with the approaches used in the banking book, a stated goal of the NPR.

iii. The drawbacks of a third-party vendor approach generally outweigh its benefits.

Members of the ASF's Ratings Alternatives Task Force have spent significant time analyzing the third-party vendor approach to calculating capital used by the National Association of Insurance Commissioners (the "**NAIC Approach**"). As members of the Task Force have discussed with representatives of the Agencies in the past, the NAIC Approach could achieve many of the Agencies' policy objectives set forth in Part I.C of the NPR and many of the guiding principles set forth above in Part III. The use of a single third-party vendor (or a small number of vendors) to calculate capital should help ensure consistency in capital calculations and would eliminate the opportunity for "ratings shopping." The level of analysis conducted by the third-party vendor and the periodic re-evaluation of

capital for a securitization position should also result in position-specific, risk sensitive capital calculations. It would also seem that supervisory oversight and calibration of capital outcomes across banking organizations would be manageable. Finally, it is a method that can be used by both large and small banking organizations.

The Associations, however, view the Revised SSFA and SFA with our proposed modifications as better approaches to calculating capital than the NAIC Approach. There are issues with using the NAIC Approach in our view that need to be considered and addressed if it were to be used as an alternative or additional method of calculating capital. As pointed out by the Agencies in the NPR, the NAIC Approach presents many of the same drawbacks as relying on credit rating agencies. The NAIC Approach continues reliance on a third party source for calculating capital. Potential conflicts of interest exist where the vendor engaged by the Agency continues to evaluate securitization positions for other clients. In addition, the "post facto" nature of the calculation of capital using this approach would make it difficult for banking organizations to properly price securitization positions in order to achieve appropriate returns on capital.

IV. Concerns with respect to the Treatment of Correlation Trading Positions

The Associations have serious concerns regarding the appropriateness of using the SSFA in determining the capital requirements for correlation trading positions under the CRM in view of the general risk insensitivity of the SSFA and the fundamental differences between correlation trading and securitization positions.[41] Further, the Associations continue to have a number of concerns with certain aspects of the Proposed MRC Rule's treatment of correlation trading positions.[42]

A. Banking organizations, whether or not required to use the Basel II advanced approaches, should be permitted to use the SFA when computing the 8% floor or 15% surcharge on correlation trading positions required under the CRM, as well as when computing the standard charges for other positions that are included in the correlation trading portfolio but are excluded from the CRM.

Banking organizations should be allowed to use the SFA, instead of the SSFA, when calculating the 8% floor or 15% surcharge under the CRM, for several reasons.

First, there are fundamental differences between correlation trading activity and other securitization activity. These differences were recognized through the carve-out for correlation trading to utilize the CRM, which generally permits banking organizations to measure material price risks using a comprehensive risk model. Underlying exposures in correlation trading portfolios generally consist of publicly traded credit default swap ("**CDS**") exposures that reference corporate credit risk and are priced by both dealer and pricing services. Unlike traditional asset-backed securitization exposures (*e.g.*, a mortgage backed security), these exposures are valued on a daily basis by the counterparties and

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[41] The 8% floor and 15% surcharge required under Sections 9(a)(2)(i)(A) and 9(a)(2)(ii)(B) of the Proposed MRC Rules, respectively, are determined using the standardized measurement method for specific risk. Accordingly, for correlation trading positions that are securitizations, the SSFA must be used in determining the applicable floor or surcharge under the CRM.

[42] We plan to address these concerns in additional detail in a subsequent letter to the Agencies.

market participants, and market participants are generally aware of any changes to the underlying portfolio (such as a merger or acquisition or realized losses based on credit events) as they occur. Current attachment and detachment points of correlation trading positions are also generally known by counterparties and market participants at all times, which is not the case with most securitization positions. In view of the differences between correlation and other securitization positions, it would not be appropriate to assign capital charges to positions that bear little resemblance to the traditional securitization positions whose capital the SSFA was designed to determine.

Second, as discussed in Part III, the SSFA has several serious flaws, including substantially overstating the amount of capital required for certain securitization exposures because of a lack of risk sensitivity. The SFA would address these flaws by permitting for a significantly more risk sensitive capital calculation than would be possible under the SSFA.

Third, the rationale for the SSFA approach is strongest for securitization exposures in which the underlying data for the SFA is difficult to source. However, as discussed above, for correlation trading, application of the SFA is feasible because the information regarding the underlying pool is available, tranche attachment and detachment are known at all times and actual tranche specifics are known and can be modeled. Additionally, all the underlying pool information is available on a regular and current basis to both market participants and their counterparties.[43]

Further, banking organizations, for similar reasons, should be able to use the SFA to determine the standard charge for leveraged super-senior positions, LCDX tranche positions and any other securitization positions that are part of the correlation trading portfolio but excluded from the CRM.

Under the U.S. risk-based capital rules, the SFA is only available to banking organizations that have been approved to use the advanced approaches. The Associations urge the Agencies to permit any banking organization, which chooses to do so and is approved by the regulators, to use the SFA with respect to correlation trading positions in light of the significant defects in the SSFA methodology and the superior risk sensitivity of the SFA. The Agencies are not required to tie the use of the SFA for purposes of calculating the CRM supervisory floor to being approved to use the advanced approaches. Any banking organization that has received the approval to determine the CRM should be permitted to utilize SFA when calculating the 8% floor or 15% surcharge, provided that it has demonstrated to the appropriate Agency that it has the necessary resources and sophistication to do so and appropriate monitoring and governance procedures in place to prevent potential arbitrage opportunities.

In the event that a banking organization opted and was approved to use the SFA to calculate the CRM supervisory floor, in order to prevent regulatory arbitrage between the SFA and the SSFA, banking organizations using the SFA should be required to apply the SFA to all correlation trading positions, other than those correlation trading positions for which the information necessary to apply the SFA was unavailable.

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[43] For obligors that are not covered by an internal rating, the bond credit spread methodology for assigning specific risk-weighting factors to corporate debt positions considered in the NPR could be used to derive LGD and PD for the SFA formula.

B. The Proposed MRC Rule's 15% surcharge is inconsistent with Basel II.5 and unnecessary, even on a temporary basis, in light of the double and triple counting of price risk.

As discussed in the April 11th Letter, the comprehensive risk measure for correlation trading positions – specified to measure "all price risk" – is duplicative of the VaR-based measure and stress VaR-measure and the modeled specific risk calculations (the latter as part of the VaR and stressed VaR calculations). Those measures encompass price risk of correlation trading positions, covering losses on a position that could result "from movements in market prices." As a result, price risk is triple-counted, reducing, if not eliminating altogether, the need to impose a 15% surcharge on a banking organization's modeled measure of price risk, even for a temporary period, as contemplated in Section 9(a)(2)(i) of the Proposed MRC Rules. Moreover, the rationale for the 15% surcharge was partly that Basel I risk-weights were previously used in the standard calculation (and were not sufficiently conservative). The Proposed Rule, however, moves away from Basel I risk-weights, further reducing the need for a surcharge of this magnitude. The proposed 15% surcharge is also not consistent with Basel II.5, which does not impose such a surcharge. Finally, firms requesting model approval under the Proposed MRC Rules have to submit rigorous and comprehensive documentation, and months of test portfolio results. Banking organizations that obtain approval for their CRM model, after this robust evaluation process, should be allowed to move directly to a specific risk calculation for correlation trading positions that is the greater of the CRM or the 8% supervisory floor, and thus should not first have to be subjected to the 15% surcharge for at least one year as required under Section 9(a)(2)(ii) of the Proposed MRC Rules.[44] For all of the foregoing reasons the Associations urge the Agencies to eliminate the 15% surcharge.

C. The specific risk add-on ("SRAO") of correlation trading positions for purposes of the 8% supervisory floor should be capped at the maximum potential loss of those positions.[45]

As stated in the April 11th Letter,[46] banking organizations should not be required to maintain capital against covered positions in an amount that exceeds the maximum loss that the banking organization could suffer under that position. This treatment should extend to the SRAO of correlation trading positions for purposes of calculating the 8% supervisory floor. Capping the SRAO of a correlation trading position at the maximum potential loss of that position is consistent both with the economics of the position and with Basel II.5.

D. Banking organizations should be permitted, but not required, to look through indices for purposes of determining the 8% supervisory floor for the CRM,[47] as well as

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[44] The Associations believe that a floor of 8%, consistent with international implementation of Basel II.5, is more appropriate than the proposed 15% surcharge.

[45] The application of maximum loss would also be applicable to the determination of the 15% surcharge should the Agencies decide to retain a surcharge.

[46] *See* Part III.A.8 of the April 11th Letter.

[47] The index look-through treatment would also be applicable to the determination of the 15% surcharge should the Agencies decide to retain a surcharge.

standard charges for positions that are part of the correlation trading portfolio but excluded from the CRM.

Both for purposes of determining the 8% supervisory floor for the CRM and for determining standard charges for positions that are part of the correlation trading portfolio but excluded from the CRM,[48] banking organizations should be permitted to look-through to the underlying names of an index.

We distinguish "decomposition" from "look-though" as follows. Decomposition into net exposure is how banking organizations view and hedge their economic exposure for correlation trading and other trading desks. It involves calculating sensitivities for the portfolio, such as delta and gamma. This method is an industry standard and well understood, but it utilizes a model to determine the net delta and other sensitivities across the correlation portfolio.

In contrast to decomposition, a "look-through" approach has no model reliance. Look-through refers to an index being broken down into its constituent parts and apportioned to its constituents. The constituents can then be netted/offset against other exposures in the same reference name. Look-through has no model dependency and therefore is only applicable to vanilla indices to be netted/offset with single name exposures. It is not applicable to tranched exposures, which do have a model dependency when decomposed into their underlying positions.

The Associations believe it is critical that the Agencies' final market risk capital rules permit banking organizations to look-through indices[49] to the underlying portfolio, and to net/offset those underlying constituents against cash equity or single name credit positions for purposes of determining the 8% supervisory floor for the CRM and more generally, when calculating standard charges for positions that are part of the correlation trading portfolio but excluded from the CRM. Permitting banking organizations to look through indices in this way would appropriately reflect the combined risk of the positions (*e.g.* long equity positions could be offset against a short equity index hedge). Allowing banking organizations to look through to the underlying portfolios would also result in capital requirements that are better aligned with the creditworthiness of the index based on its constituents and would provide the correct incentive to hedge the risks of such positions.[50]

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48 As discussed in Part III.F, the Associations strongly believe that a "look-through" approach should also be permitted when risk weighting securitization exposures.

49 Indices for these purposes include equity, credit and mortgage and other asset-backed indices.

50 In a planned subsequent letter, the Associations anticipate providing additional detail on the appropriate offsetting treatment across bespoke and CDS positions and potentially across other positions under Sections 10(a)(4) and 10(a)(5) of the Proposed MRC Rules when determining the 8% floor and 15% surcharge for the CRM.

E. At a minimum, non-securitization index and single name CDS hedges should be removed from the standard charges (i) within the 15% surcharge and the 8% floor and (ii) for positions that are part of the correlation trading portfolio but excluded from the CRM.

The proposed standardized charges under the Proposed MRC Rules for correlation trading positions penalize banking organizations for hedging these positions with vanilla products, because the offsetting benefit of these hedges is not recognized and the hedges themselves attract separate capital charges. A significant portion of the 15% surcharge, the 8% floor and standard charges for positions that are part of the correlation trading portfolio but excluded from the CRM (*e.g.*, LCDX index tranches) would arise from capital attracted by non-securitization index and single name CDS hedges under the Proposed MRC Rules, thereby discouraging banking organizations from buying such hedges. Although our preference would be for the Agencies to permit appropriate hedge recognition (as discussed above in Part III.D), at a minimum, in order to align capital rules with effective risk management practices, we urge the Agencies to remove non-securitization index and single name CDS hedges from such requirements.

We recognize that, if the Agencies allow the offsetting treatment described above, there is a risk that a banking organization may attempt to engage in regulatory arbitrage by claiming that positions outside the correlation trading portfolio are hedges of correlation trading positions in order to receive potentially more favorable capital treatment. We believe, however, that this risk is manageable. As part of the CRM model approval process, we would expect supervisors to insist on appropriate documentation of, and systems and controls for tracking and monitoring, correlation trading positions to prevent opportunistic reclassifications of non-correlation trading positions for regulatory capital purposes, such that any attempts to engage in regulatory arbitrage would be easily identified and prevented or reclassified.

V. Additional Concerns

A. The Proposed Rule could, in practice, impose capital requirements in excess of dollar-for-dollar capital.

Under the Agencies' current market risk capital rules,[51] market risk equivalent assets are added to adjusted risk-weighted assets for purposes of calculating a banking organization's risk-based capital ratio denominator.[52] Market risk equivalent assets, in turn, are calculated by multiplying the measure for market risk by 12.5, and the measure for market risk is determined by summing up several capital charges, including the specific risk add-on.[53] Thus, for example, specific risk-weighting factors of 1.6% and 8% are equivalent to risk weightings of 20% and 100%, respectively.

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[51] *See* 12 C.F.R., part 3, Appendix B (OCC); 12 C.F.R., part 208, Appendix E and 12 C.F.R. part 225, Appendix E (Federal Reserve); 12 C.F.R., part 325, Appendix C (FDIC).

[52] *See, e.g.*, 12. C.F.R., part 225, Appendix E, § 3(a)(4).

[53] *See, e.g.*, *Id.* §§ 3(a)(2), (a)(3).

As a consequence of the way market risk equivalent assets are calculated, a specific risk-weighting factor of 100% is equivalent to a risk weighting of 1250%. Assuming an 8% total risk based capital requirement, a specific risk-weighting factor of 100% is generally equivalent to a dollar-for-dollar capital requirement. However, if the total risk based capital requirement in effect exceeds 8%, then a banking organization will be required to hold more than dollar-for-dollar capital for exposures that have a 100% specific risk-weighting factor. Minimum total capital requirements (including the capital conservation buffer) under Basel III on a fully phased-in basis will be 10.5%, and thus will exceed 8%.[54] Furthermore, banking organizations will need to hold additional capital buffers as a practical matter given regulatory and market expectations, U.S. requirements concerning capital maintenance levels under stressed scenarios and volatility because Basel III does not filter accumulated other comprehensive income from Tier 1 capital.

If a principal purpose of capital requirements is to protect a banking organization against expected potential losses, it is not sensible to impose capital requirements in excess of an exposure's maximum potential loss. The Associations therefore urge the Agencies to continue to provide banking organization with the options of calculating a dollar-for-dollar capital charge using the "direct reduction method", which is currently permitted in Call Reports. A banking organization that uses this method calculates its capital requirement using the actual amount of the banking organization's total risk-based capital. The direct reduction method replicates a deduction from capital and does not result in banking organization's holding more capital than an asset's carrying value. For a banking organization the capital ratios of which exceed the required minimums, it is normally preferable to use the "direct reduction method."

VI. Responses to Certain Specific Questions

Below are cross-references to parts of the letter that we believe are responsive to part or all of the questions posed by the Agencies in the NPR.

A. Question 2: The agencies solicit comment on the use of the CRC ratings to assign specific risk-weighting factors to sovereign debt positions.

Please see Part II.A.

B. Question 3: How well does the proposed methodology assign specific risk-weighting factors to sovereign debt positions that are commensurate with the relative risk of such exposures? How could it be improved? What are the relative merits of the two market-based alternatives described above (using sovereign CDS spreads and bond spreads) as supplements to the CRC ratings?

Please see Part II.A.

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[54] For "global systemically important banks", minimum total capital requirements could be between 1% and 3.5% higher than 10.5%. The countercyclical capital buffer, if imposed by the Agencies, would also increase total minimum capital requirements above 10.5%.

C. Question 4: How well does the proposed methodology assign specific risk-weighting factors that are commensurate with the relative risk of positions that are exposures to depository institutions, foreign banks, and credit unions?

Please see Part II.C.

D. Question 5: Does the method of assigning specific risk-weighting factors to positions that are exposures to PSEs do so in a manner that is consistent and commensurate with the relative risk of such exposures? How could it be improved?

Please see Part II.D.

E. Question 8: How well does the three-indicator methodology capture credit risk for purposes of assigning risk-based capital requirements for covered debt positions of publicly-traded companies that are not financial institutions? How could it be improved?

Please see Part II.E.

F. Question 9: How does the bond spreads alternative to credit ratings compare to the proposed approaches regarding operational feasibility and reliability in assessing risk and an appropriate amount of capital?

Please see Part II.E.ii.

G. Question 10: For what types of positions would the bond-spread approach be most appropriate, and for what types of positions would it not be appropriate? Are there measures of market liquidity or other factors that the agencies should consider in evaluating the applicability of a credit spread approach?

Please see Part II.E.ii.

H. Question 11: What are the pros and cons of a more simple approach, which distinguishes only among investment grade and non-investment grade corporate debt positions (the "investment grade methodology") relative to the more granular three-indicator methodology? What are the pros and cons of offering the investment grade/non-investment grade (under the OCC's proposed revisions to 12 CFR part 1) approach as an alternative for banks that do not use the three-indicator approach?

Please see Part II.F.

I. Question 12: Is the SSFA function appropriately calibrated and would it be a feasible and appropriate methodology for assigning specific risk add-ons for securitization positions? Why or why not? Are the minimum risk-weighting factors appropriate and appropriately calibrated? Why or why not? Please provide detailed responses and supporting data wherever possible.

Please see the discussion in Part III.A.

J. Question 13: What are the benefits and drawbacks to using a scaling factor to better align the minimum capital requirements under the SSFA with those generated by the ratings-based approach? What other adjustments could the agencies consider to better recognize credit enhancements and align the minimum capital requirements? Please provide specific details on the mechanics of, and rationale for, any suggested methodology and the position types to which it should apply. How should an adjustment, such as a scaling factor, be implemented? For example, should it take into account the type of credit enhancement, asset class, loss experience, prudential requirements, or other criteria, and if so how and why?

Please see Parts III.B through III.E.

K. Question 14: What are the pros and cons of incorporating the concentration ratio into the market risk capital rules as a replacement or alternative to the SSFA?

Please see Part III.G.i.

L. Question 15: In what instances and for what types of securitization positions should the concentration ratio be used? For what types of securitization positions does the concentration ratio produce a specific risk-weighting factor that is better aligned with the risk inherent in the position than the SSFA?

Please see Part III.G.i.

M. Question 16: Is the spread-based methodology feasible for assigning securitization positions to specific risk-weighting factors? What are the particular types of securitization positions for which it is more or less feasible, and why?

Please see Part III.G.ii.

N. Question 17: Would the spread-based methodology be more or less effective as a methodology for assigning specific risk-weighting factors for securitization positions than the proposed methodology using the SSFA? What difficulties or challenges would a bank have in assigning specific risk-weighting factors for securitization positions under this approach?

Please see Part III.G.ii.

O. Question 18: What limitations currently exist with respect to banks' ability to obtain reliable spread data for securitization positions, including illiquid positions? If the third-party vendor approach is implemented, how could banks demonstrate to supervisors sufficient access to such information to use the methodology?

Please see Part III.G.iii.

P. Question 19: Given concerns noted above, what would be the advantages and disadvantages of a third-party vendor approach, particularly relative to the proposed SSFA approach?

Please see Part II.G.iii.

Q. Question 20: Should banks that are approved to use the advanced approaches be allowed to use the advanced approaches SFA to calculate specific risk-weighting factors for their securitization positions under the market risk capital rules? If the advanced approaches banks are permitted to use SFA, what safeguards should be put in place to mitigate arbitrage concern?

Please see Part III.D.

R. Question 21: How could the SFA be modified to permit the use of pool-level inputs to increase the applicability of the SFA for banks as investors? What effect would the use of pool-level inputs and the recognition of cash flow hedges have on the risk sensitivity of the SFA? To what extent does use of pool-level inputs camouflage the risk inherent in an asset pool? Are there other issues that should be considered if pool-level inputs are used?

Please see Part III.D.

VII. Conclusion

In view of the significant shortcomings in the Proposed Rule's methodologies and the potentially significant impact that the Proposed Rule could have on capital requirements, we respectfully urge the Agencies not to implement any alternative methodologies before the Associations, their members and other interested parties have had an opportunity to more thoroughly review the proposed methodologies and more fully develop potential alternatives in conjunction with the Agencies, and the Agencies undertake a quantitative impact study (a "**QIS**") to determine the comparability of the Proposed Rule's alternative methodologies to Basel II.5's ratings-based approach as well as to assess the impact of the Proposed Rule on banking organizations, the availability and cost of credit and the U.S. economy. Once these potential alternatives have been more fully developed and a QIS has been completed, we urge the Agencies to re-publish the Proposed Rule for further comment given the potentially significant impact that the Proposed Rule's methodologies will have not only on capital requirements under the Agencies' market risk capital rules, but also on the capital requirements under the general risk-based rules to the extent similar methodologies are incorporated in those rules. We strongly believe that a re-publication of the Proposed Rule following the completion of a QIS and additional work on proposed alternative methodologies would lead to better calibrated, more risk sensitive approaches that are more closely aligned with international standards and better promote the Agencies' objectives set forth in the NPR.

We fully recognize and appreciate that the various issues raised in this letter concerning the NPR and the Proposed Rule, including with respect to sovereign debt and corporate debt, securitization and correlation trading, are quite challenging and complex. We look forward to meeting and working together with the Agencies in the coming weeks to more fully develop sensible and practical solutions with respect to these matters.

* * *

The Associations appreciate your consideration of the views expressed in this letter. If you have any questions, or need further information, please contact Eli Peterson, Senior Regulatory Counsel and Associate General Counsel of The Clearing House (202-649-4602) or one of the other signatories below. If you need any further information regarding the matters discussed in Part III of this letter, please contact Tom Deutsch, Executive Director of the ASF (212-412-7107).

Respectfully Submitted,

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The Clearing House

Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs and white papers—the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the United States. *See* The Clearing House web page at www.theclearinghouse.org.

American Bankers Association

The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its two million employees. The majority of ABA's members are banks with less than $165 million in assets. Learn more at www.aba.com.

American Securitization Forum

The American Securitization Forum is a broad-based professional forum through which participants in the U.S. securitization market advocate their common interests on important legal, regulatory and market practice issues. ASF members include over 330 firms, including issuers, investors, servicers, financial intermediaries, rating agencies, financial guarantors, legal and accounting firms, and other professional organizations involved in securitization transactions. ASF also provides information, education and training on a range of securitization market issues and topics through industry conferences, seminars and similar initiatives. For more information about ASF, its members and activities, please go to www.americansecuritization.com.

The Financial Services Roundtable

The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $92.7 trillion in managed assets, $1.2 trillion in revenue, and 2.3 million jobs.

International Swaps and Derivatives Associations

The International Swaps and Derivatives Associations ("**ISDA**"), which represents participants in the privately negotiated derivatives industry, is among the world's largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985 and today has over 800 member institutions from 54 countries on six continents. Our members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end-users that rely on over-the-counter derivatives to manage efficiently the risks inherent in their core economic activities. For more information, please visit: www.isda.org.

Securities Industry and Financial Markets Association

SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

Annex B

Standard Specific Risk: *Sovereigns*

Comparison: *BIS 2.5 MR to US NPR Risk Weights on Sovereign Debt*

CRC	Change	RW Change	# of Countries
0-1	Lower	150% → 0%	1
	Same	100% → 0%	6
		20% → 0%	10
		0%	19
2-3	Lower	100% → 20%	8
	Same	20%	16
	Higher	0% → 20%	3
4-6	Same	100%	49
	Higher	20% → 100%	6
7	Same	150%	1
	Higher	100% → 150%	47
No CRC	Same	100% → 100%	40
	Higher	20% → 100%	2
		0% → 100%	2
Total			**210**

Impact: *Significantly lower capital charges for OECD sovereigns, compared to BIS 2.5 MR.*

Standard Specific Risk: *IG Corporates*

Comparison: *BIS 2.5 MR to US NPR Risk Weights for IG 15*

S&P Equivalent	Change	RW Change	# of Issuers
AAA	Higher	20% → 100%	1
AA	Higher	20% → 100%	3
A	Higher	20% → 100%	31
BBB	Higher	20% → 100%	78
BB	Same	100%	7
NR	Same	100%	5
Total			**125**

Change	# of Issuers
Lower	0
No Change	12
Higher	113
Total	**125**

Comparison: *Basel 1 to US NPR Risk Weights for IG 15*

S&P Equivalent	Change	RW Change	# of Issuers
AAA	Higher	20% → 100%	1
AA	Higher	20% → 100%	3
A	Higher	20% → 100%	31
BBB	Higher	20% → 100%	78
BB	Same	100%	7
NR	Same	100%	5
Total			**125**

Change	# of Issuers
Lower	0
No Change	12
Higher	113
Total	**125**

Impact: *90% of IG names migrate from 20% to 100% compared to both BIS 2.5 MR and Basel 1.*

Annex C

Figure 1 (% IG not classified as low risk among DTCC's 1000 most actively traded names as of 1/13/12)

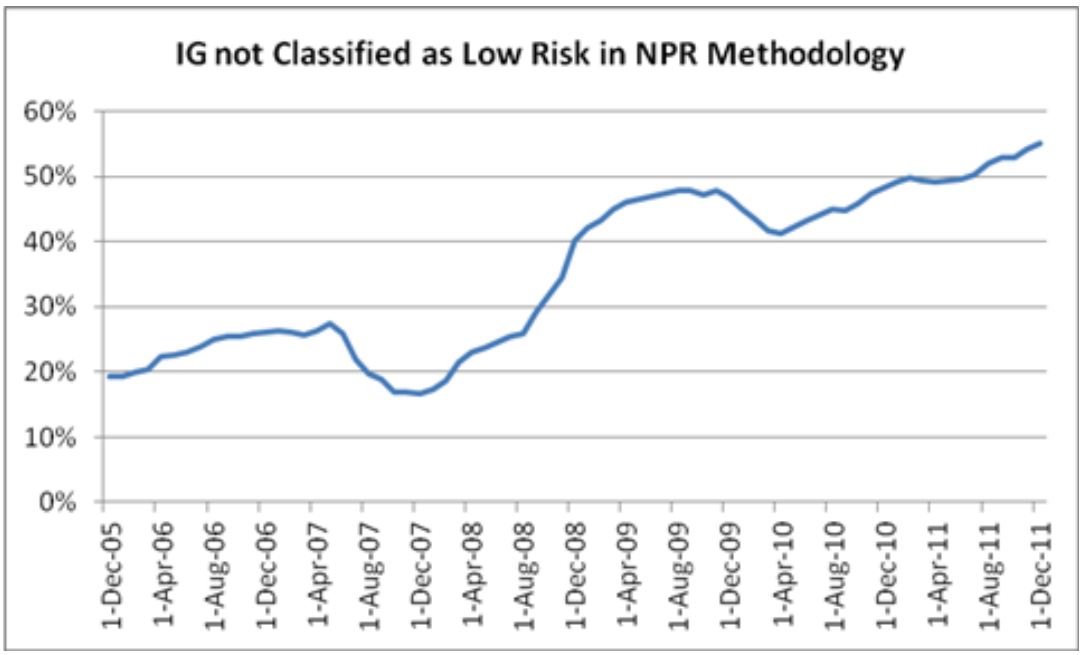


Figure 2 (% of misclassified DTCC's 1000 most actively traded names as of 1/13/12)

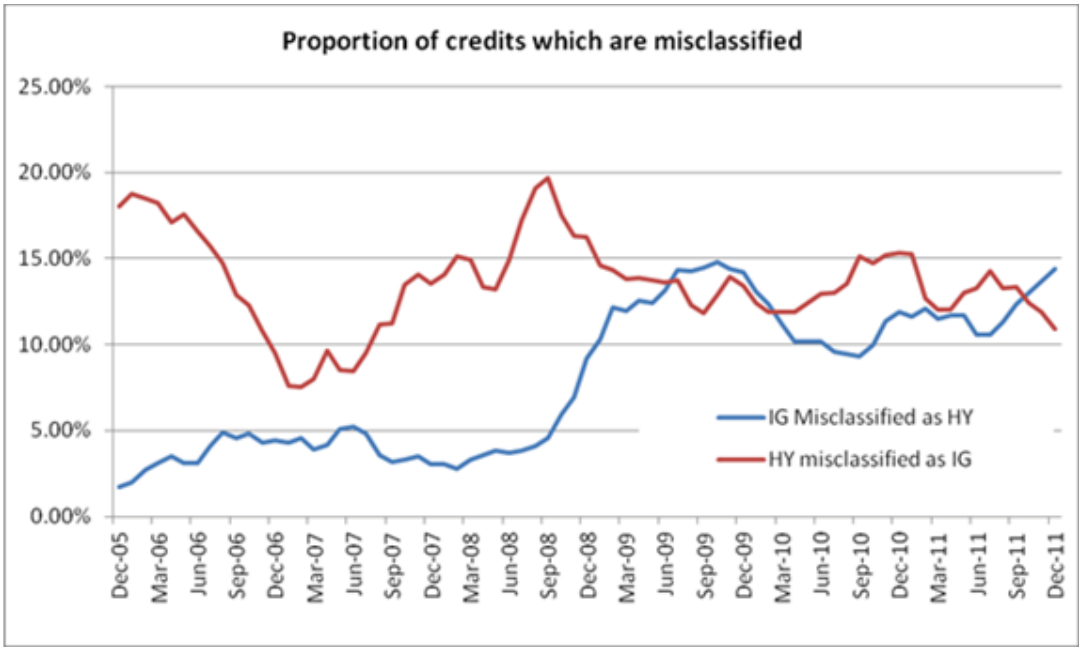
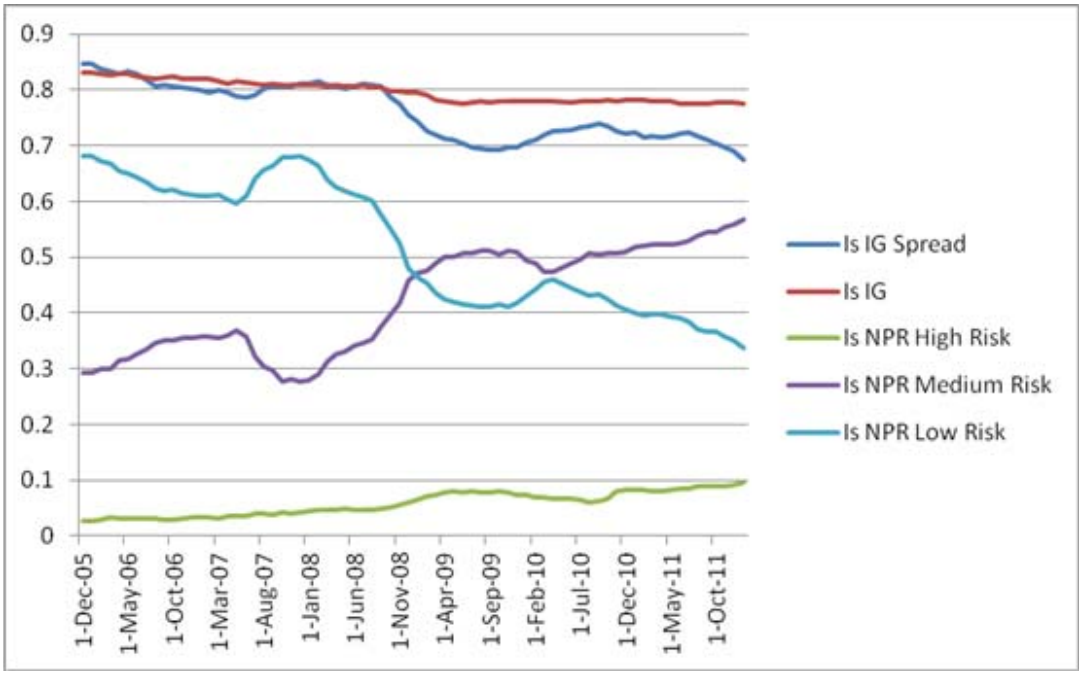


Figure 3 (% of DTCC's 1000 most actively traded names as of 1/13/12 in different categories)



Annex D

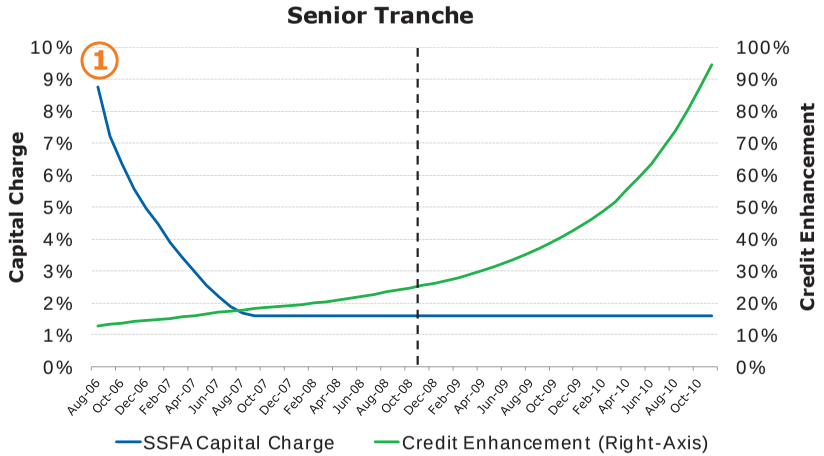
Specific Concern with the NPR SSFA, Section (III)(B)(i)

K_G is a highly risk insensitive measure for calculating the required capital for exposures underlying a securitization exposure

Higher capital charge for a prime auto senior bond, compared to a subprime auto senior bond

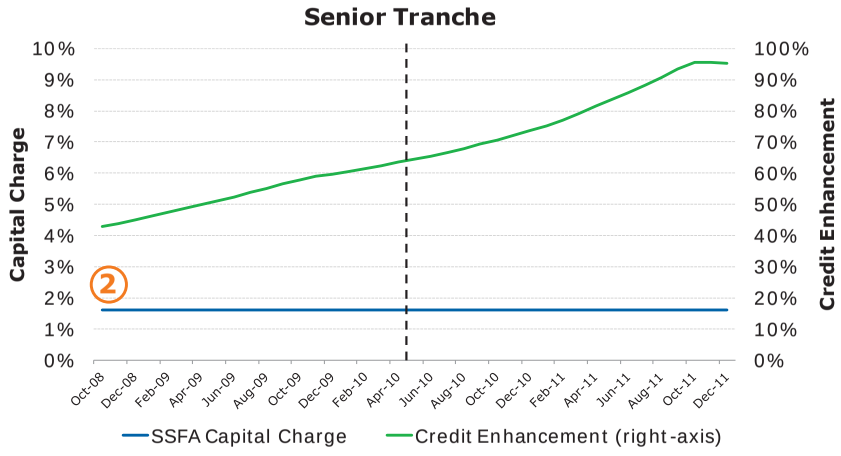
- K_G, in its proposed form, does not distinguish the credit risk associated with a particular exposure within an asset class
- The example below illustrates how the SSFA, as proposed, results in a higher capital charge for the senior bond in a prime auto securitization (FORDO 2006-B) compared to the senior bond in a subprime auto securitization (AmeriCredit 2008-1)
  - ① FORDO 2006-B capital charge at issuance: 8.77%
  - ② AmeriCredit 2008-1 capital charge at issuance: 1.60%
- Risk insensitivity and resulting inappropriate capital charges are due to an arbitrary K_G value of 8% for both trusts

FORDO 2006-B Capital Charges Over Time



Date	08/15/2006	11/15/2008	11/15/2010
Tranche	A-4	A-4	A-4
Capital Charge	8.77%	1.60%	1.60%
Moody's/S&P	Aaa/AAA	Aaa/AAA	Aaa/AAA
Inputs			
A	12.64%	25.56%	94.64%
D	26.49%	63.78%	100.00%
KG	8.00%	8.00%	8.00%
p	50.00%	50.00%	50.00%
Carrying Value	100.00%	100.00%	100.00%
Cumulative Loss (on collateral) %	0.00%	1.31%	2.10%
Cumulative Loss (on securities) %	0.00%	0.00%	0.00%

AmeriCredit 2008-1 Capital Charges Over Time



Date	10/06/2008	05/06/2010	01/06/2012
Tranche	A-3	A-3	A-3
Capital Charge	1.60%	1.60%	1.60%
Moody's/S&P	Aaa/AAA	Aaa/AAA	Aaa/AAA
Inputs			
A	42.75%	64.62%	94.98%
D	54.02%	83.52%	100.00%
KG	8.00%	8.00%	8.00%
p	50.00%	50.00%	50.00%
Carrying Value	100.00%	100.00%	100.00%
Cumulative Loss (on collateral) %	0.00%	9.29%	14.81%
Cumulative Loss (on securities) %	0.00%	0.00%	0.00%

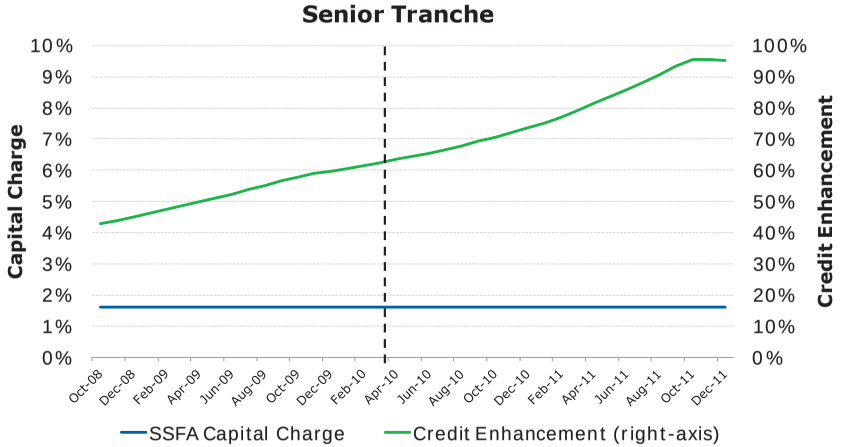
Specific Concern with the NPR SSFA, Section (III)(B)(i)

K_G is a highly risk insensitive measure for calculating the required capital for exposures underlying a securitization exposure

Same capital charge for a trust's senior bond as its riskier junior bond

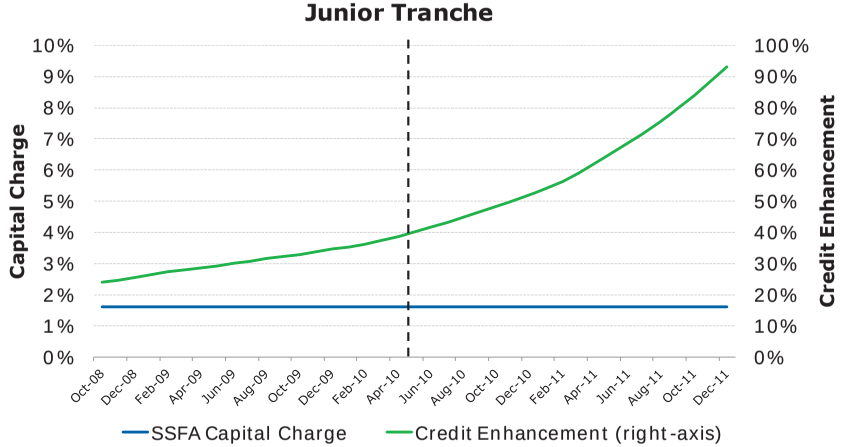
- K_G, in its proposed form, does not increase beyond 8%, even for asset classes with expected and unexpected losses in excess of 8%
- The example below illustrates how the SSFA, as proposed, results in an identical capital charge for both the senior bond and the junior bond in a subprime auto securitization (AmeriCredit 2008-1)
  - The senior bond has initial credit enhancement of 42.75%, compared to the junior bond's initial credit enhancement of 23.87%
  - Such risk insensitivity may not foster prudent risk management as banks would be incentivized to hold riskier bonds

AmeriCredit 2008-1 Capital Charges Over Time



Date	10/06/2008	05/06/2010	01/06/2012
Tranche	A-3	A-3	A-3
Capital Charge	1.60%	1.60%	1.60%
Moody's/S&P	Aaa/AAA	Aaa/AAA	Aaa/AAA
Inputs			
A	42.75%	64.62%	94.98%
D	54.02%	83.52%	100.00%
KG	8.00%	8.00%	8.00%
p	50.00%	50.00%	50.00%
Carrying Value	100.00%	100.00%	100.00%
Cumulative Loss (on collateral) %	0.00%	9.29%	14.81%
Cumulative Loss (on securities) %	0.00%	0.00%	0.00%

AmeriCredit 2008-1 Capital Charges Over Time



Date	10/06/2008	05/06/2010	01/06/2012
Tranche	C	C	C
Capital Charge	1.60%	1.60%	Paid Down
Moody's/S&P	A3/A	A3/A	Paid Down
Inputs			
A	23.87%	40.13%	Paid Down
D	34.90%	51.47%	Paid Down
KG	8.00%	8.00%	8.00%
p	50.00%	50.00%	50.00%
Carrying Value	100.00%	100.00%	100.00%
Cumulative Loss (on collateral) %	0.00%	9.29%	14.81%
Cumulative Loss (on securities) %	0.00%	0.00%	0.00%

Specific Concern with the NPR SSFA, Section (III)(B)(ii)

Determining the supervisory risk-weight floor based on the ratio of cumulative losses to K_G in the manner contemplated by the Proposed Regulations is not an appropriate benchmark of credit quality

The supervisory floor can require a 100% capital charge for a senior bond with 92% credit enhancement; which is the same capital charge for a junior bond with only 7% credit enhancement

- The supervisory floor, as proposed, can result in situations in which more risky junior tranches of a securitization have higher capital requirements, but the most senior positions ***do not*** have relatively lower capital requirements

Trust	HEAT 2006-5
Collateral Type	Home Equity
Tranche	2A2
Moody's/S&P	Aa3/AAA
Date	03/25/2011
A	**91.59%**
D	**100.00%**
p	0.5
K_G	8.00%
Cumulative Net Losses on Issued Securities	17.24%
Cumulative Net Losses on Underlying Exposures	24.19%
K_{SSFA} Core Formula Capital Charge	0.00%
Supervisory Floor Capital Charge	100.00%
Overall Capital Charge	**100.00%**

Trust	HEAT 2006-5
Collateral Type	Home Equity
Tranche	2A4
Moody's/S&P	C/CCC
Date	03/25/2011
A	**6.79%**
D	**34.76%**
p	0.5
K_G	8.00%
Cumulative Net Losses on Issued Securities	17.24%
Cumulative Net Losses on Underlying Exposures	24.19%
K_{SSFA} Core Formula Capital Charge	0.00%
Supervisory Floor Capital Charge	100.00%
Overall Capital Charge	**100.00%**

Identical Capital Charges

Annex E

Proposed Modifications, Section (III)(C)(i)(i)

The following modifications to the currently proposed NPR SSFA can help produce more risk-sensitive capital charges for securitization exposures

- To increase the risk-sensitivity of the SSFA, K_G, the weighted-average capital requirement, should be based on non-arbitrary values, by asset class, that represent unexpected losses of the underlying exposures

Expanded Table of Weighted-Average Capital Requirements	
Asset Type	**Loan Capital Requirement**
Prudently Underwritten Mortgages	4.00%
Prime Bank Credit Cards	4.00%
Prime Auto Loans	4.00%
Other Low Loss Assets	4.00%
All Other	Consistent with General Risk Based Capital

Proposed Modifications, Section (III)(C)(i)(ii)

The following modifications to the currently proposed NPR SSFA can help produce more risk-sensitive capital charges for securitization exposures and is in-line with current risk-based capital rules on loans

- Redefine K_G to include reserves for losses against non-performing loans
  - Redefining K_G to reflect the sum of risk-based capital on loans (based on the table in the previous slide), plus loan loss reserves, would bring required capital on securitizations in sync with how loans would be treated on a bank's balance sheet
  - K_G is redefined as follows:

    *(a) the weighted-average capital requirement of the **performing** underlying exposures calculated using the expanded table of general risk-based capital values (see previous slide), plus (b) the expected losses on seriously delinquent underlying exposures calculated using the 3-month loss severity[1] on the underlying exposures*
  - Formulaically:

$$K_G = \left(\left(1 - \%\ \text{of Underlying Exposures Greater than 90 Days Past Due}\right) \times \text{Weighted Average Capital Requirement}\right) + \left(\%\ \text{of Underlying Exposures Greater than 90 Days Past Due} \times \text{3 month severity}^{1}\right)$$

  - K_G is updated quarterly

1. If historical severity is not available, a severity of 50% is used as a proxy

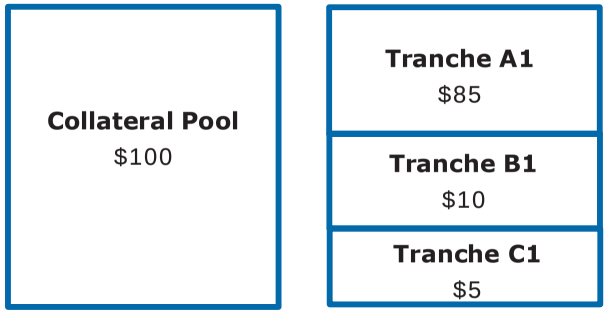
Proposed Modifications, Section (III)(C)(ii)

A security held at a discount to par carries less risk than the same security held at par, and as such, should require a lower risk-based capital charge in the SSFA

Carrying value is an important component of credit enhancement and should be in included in the attachment point; it is not applied to directly deduct capital

- The example securitization structure shown below includes three tranches (A1, B1, and C1) that are sequential for interest and principal payments. Tranche A1 and B1 were purchased at a 25% discount

Example Securitization Structure



Tranche A1 SSFA Inputs

K_G	8%
p	0.5
A	15%
D	100%
Carrying Value	75%

Tranche B1 SSFA Inputs

K_G	8%
p	0.5
A	5%
D	15%
Carrying Value	75%

- Carrying value can be incorporated into the SSFA methodology by modifying the calculation of the attachment point variable, A, to reflect an increase in the credit enhancement by an absolute percent of the discount factor from par on the thickness of the security, as follows:

Modification to the SSFA

$$\text{Parameter } A = A + (D - A) * (1 - C)$$

$$C = \frac{\text{Carrying value of security}}{\text{Par value of security}}$$

Results of modification

Tranche A1	NPR SSFA	Modified SSFA
A	15.00%	15.00%
$A_{modified}$	-	36.25%
Capital Charge	**1.6%[1]**	**1.6%[1]**

Tranche B1	NPR SSFA	Modified SSFA
A	5.00%	5.00%
$A_{modified}$	-	7.50%
Capital Charge	**63.05%**	**50.73%**

1. Capital charge of 1.60% is representative of the SSFA floor, as proposed in the NPR. The revised version of the SSFA, including all of the proposed changes, would result in a capital charge of 0.56% due to the revised floor

Proposed Modifications, Section (III)(C)(iii)(i)

A K_{SSFA} formula that appropriately accounts for the risk of a security with a proper K_G value, attachment point, detachment point, and calibration parameter will produce suitable capital charges

- A single risk-weight floor that is equal to the minimum risk-weight floor applicable to securitization positions under the Basel II advanced approaches as in effect from time to time
- A ceiling (maximum) is introduced on the capital charge of the most senior tranche in a securitization that is equal to K_G, where the most senior tranche is defined as the tranche with a detachment point of 100% (as proposed in 1(d) of the 'Summary of Proposed Changes' section)
  - Securitizations are subject to this ceiling, however, re-securitizations are ***not*** subject to this ceiling

Proposed Modifications, Section (III)(C)(iii)(ii)

A supervisory floor that contemplates the structural features of a trust will result in non-arbitrary and more appropriate capital charges

Any supervisory floor table should be:

a) more granular to reduce the cliff impact and make increases in capital more gradual as performance warrants such increases, and

b) incorporate attachment point to differentiate between less risky senior tranches and riskier junior tranches

- The supervisory floor (NPR Table 15) calculation is adjusted to better reflect the risk of a security
  - The supervisory floor metric is adjusted to account for the seniority of a security by including Parameter A:

$$\text{Supervisory Floor Metric} = \frac{\text{Cumulative Losses of Principal on Originally Issued Securities (as a \%)}}{K_G \text{ at Origination (as a \%)} + \text{Current Period Parameter A (as a \%)}}$$

  - The supervisory floor table is adjusted to become more granular and better reflect the risk-level of a securitization exposure, as shown below:

CLP / (K_{GI} + Parameter A)		Specific Risk-weighting Factor (in percent)
Greater than:	Less than or equal to:	
0%	25%	0.56
25%	30%	0.64
30%	40%	0.80
40%	50%	1.60
50%	60%	2.80
60%	70%	4.00
70%	85%	6.00
85%	100%	8.00
100%	115%	20.00
115%	130%	34.00
130%	150%	52.00
150%	n/a	100.00

Where,

CLP = cumulative losses of principal on originally issued securities as a percentage of the original principal amount of such securities

K_{GI} = the initial K_G of the relevant securitization exposures (expressed as a percentage)

Parameter A = the attachment point, modified to reflect carrying value, of the securitization position at the time of calculations (expressed as a percentage)

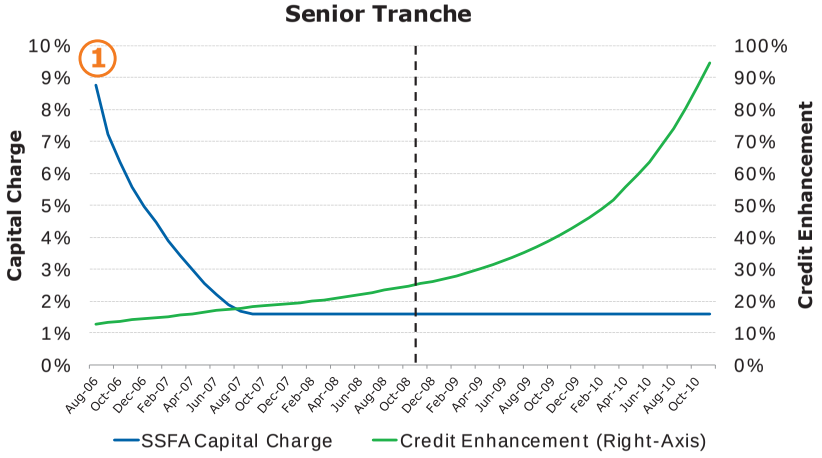
  - A ceiling (maximum) is introduced in the supervisory floor capital charge calculation for the most senior tranche in ***both*** securitizations and re-securitizations that is equal to K_G, where the most senior tranche is defined as the tranche with a detachment point of 100% (as proposed in 1(d) of the 'Summary of Proposed Changes' section)

Results of Revised SSFA

K_G, as proposed in the NPR, is a risk insensitive measure for calculating the required capital for exposures underlying a securitization exposure

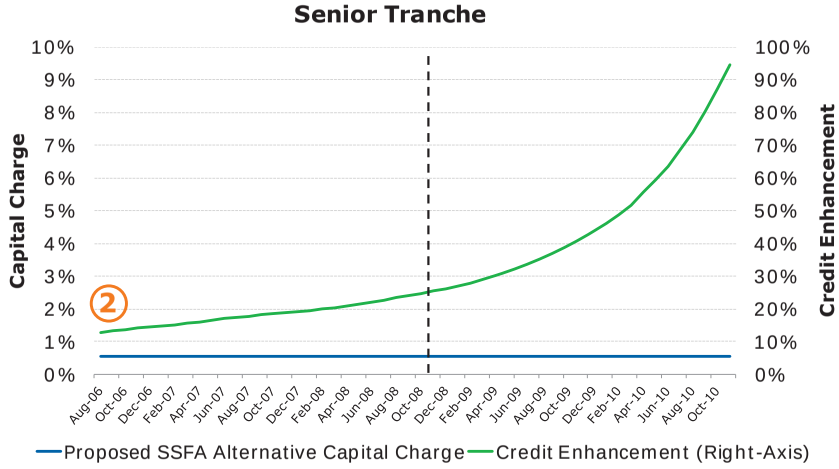
- Incorporating a more risk sensitive measure for K_G results in capital charges that are more appropriate for each type of asset class
- The example below illustrates how the proposed changes to SSFA results in a ***more appropriate*** capital charge for the senior bond in a ***prime*** auto securitization (FORDO 2006-B) than would be required from the current SSFA
  - ① FORDO 2006-B capital charge at issuance (current SSFA): 8.77%
  - ② FORDO 2006-B capital charge at issuance (revised SSFA): 0.56%

FORDO 2006-B Capital Charges (current SSFA)



Date	08/15/2006	11/15/2008	11/15/2010
Tranche	A-4	A-4	A-4
Capital Charge	8.77%	1.60%	1.60%
Moody's/S&P	Aaa/AAA	Aaa/AAA	Aaa/AAA
Inputs			
A	12.64%	25.56%	94.64%
D	26.49%	63.78%	100.00%
KG	8.00%	8.00%	8.00%
p	50.00%	50.00%	50.00%
Carrying Value	100.00%	100.00%	100.00%
Cumulative Loss (on collateral) %	0.00%	1.31%	2.10%
Cumulative Loss (on securities) %	0.00%	0.00%	0.00%

FORDO 2006-B Capital Charges (revised SSFA)



Date	08/15/2006	11/15/2008	11/15/2010
Tranche	A-4	A-4	A-4
Capital Charge	0.56%	0.56%	0.56%
Moody's/S&P	Aaa/AAA	Aaa/AAA	Aaa/AAA
Inputs			
A	12.64%	25.56%	94.64%
D	26.49%	63.78%	100.00%
KG	4.00%	4.36%	5.47%
p	50.00%	50.00%	50.00%
Carrying Value	100.00%	100.00%	100.00%
Cumulative loss (on securities) %	0.00%	0.00%	0.00%
Seriously Delinquent Loans	0.00%	0.40%	2.32%
Historical Severity	0.00%	94.39%	67.22%
Cumulative loss (on collateral) %	0.00%	1.31%	2.10%

Results of Revised SSFA

Determining the risk weight floor based on the ratio of cumulative losses to K_G in the manner contemplated by the Proposed Regulations is not an appropriate benchmark of credit quality

- Including a supervisory floor table that allows the core SSFA equation to appropriately calculate capital charges results in capital charges that are both risk sensitive and will not incentivize banks to hold riskier assets based on capital charges
- The example below illustrates how the proposed changes to SSFA results in a ***high*** capital charge for a tranche with ***little credit enhancement and thickness,*** however, a ***lower*** capital charge for a tranche with exceedingly ***higher credit enhancement and thickness***
  - The super senior bond (2A2) has a capital charge of 6.35% with attachment point, A, of 91.59% and detachment point, D, of 100%
  - The senior bond (2A4) has a capital charge of 100% with attachment point, A, of 6.79% and detachment point, D, of 34.76%

Trust	HEAT 2006-5
Collateral Type	Home Equity
Tranche	2A2
Moody's/S&P	Aa3/AAA
Date	03/25/2011
A	91.59%
D	100.00%
p	0.5
Discount/Premium to Par	95.00%
Parameter A	92.01%
K_G at Origination	8.00%
Cumulative Net Losses on Issued Securities	17.24%
Cumulative Net Losses on Underlying Exposures	24.19%
90+ Days Past Due Rate	41.42%
Historical 3-Month Severity Rate	86.00%
K_G	40.31%
K_G at Origination + Parameter A	100.00%
K_{SSFA} Core Formula Capital Charge	6.35%
Supervisory Floor Capital Charge	0.56%
Overall Capital Charge	**6.35%**

Trust	HEAT 2006-5
Collateral Type	Home Equity
Tranche	2A4
Moody's/S&P	C/CCC
Date	03/25/2011
A	6.79%
D	34.76%
p	0.5
Discount/Premium to Par	85.00%
Parameter A	10.99%
K_G at Origination	8.00%
Cumulative Net Losses on Issued Securities	17.24%
Cumulative Net Losses on Underlying Exposures	24.19%
90+ Days Past Due Rate	41.42%
Historical 3-Month Severity Rate	86.00%
K_G	40.31%
K_G at Origination + Parameter A	18.99%
K_{SSFA} Core Formula Capital Charge	100.00%
Supervisory Floor Capital Charge	8.00%
Overall Capital Charge	**100.00%**

Capital Charge Reflecting the Risk of Each Tranche

Annex F

Revised SSFA Example Calculations

The examples below illustrate the SSFA calculation under Revised SSFA, compared to the SSFA calculation based on the NPR

- Examples include scenarios at various points in time and different collateral deterioration assumptions for six different securities within the same trust

Collateral Full Performance

Time: Securitization Settlement
Total Principal Received: 0 | **K_G at Origination:** 4.00%
Total Losses Realized: 0 | **Calibration Parameter:** 50.00%
Seriously Delinquent: 0%
Loss Severity: 0%

	Size	Attach	Detach	Price	Revised SSFA	NPR SSFA
Senior	92,000,000	8.00%	100.00%	100	0.56%	1.60%
Mezz	2,500,000	5.50%	8.00%	100	26.96%	26.96%
Mezz	2,000,000	3.50%	5.50%	100	85.87%	85.87%
Mezz	1,250,000	2.25%	3.50%	100	100.00%	100.00%
Mezz	1,250,000	1.00%	2.25%	100	100.00%	100.00%
Sub	1,000,000	0.00%	1.00%	100	100.00%	100.00%
	100,000,000				6.41%	7.36%

Time: Settlement + 12 months
Total Principal Received: 5,000,000 | **K_G at Origination:** 4.00%
Total Losses Realized: 0 | **Calibration Parameter:** 50.00%
Seriously Delinquent: 0%
Loss Severity: 0%

	Size	Attach	Detach	Price	Revised SSFA	NPR SSFA
Senior	87,000,000	8.42%	100.00%	100	0.56%	1.60%
Mezz	2,500,000	5.79%	8.42%	100	22.73%	22.73%
Mezz	2,000,000	3.68%	5.79%	100	76.56%	76.56%
Mezz	1,250,000	2.37%	3.68%	100	100.00%	100.00%
Mezz	1,250,000	1.05%	2.37%	100	100.00%	100.00%
Sub	1,000,000	0.00%	1.05%	100	100.00%	100.00%
	95,000,000				6.41%	7.36%

Time: Settlement + 24 months
Total Principal Received: 10,000,000 | **K_G at Origination:** 4.00%
Total Losses Realized: 0 | **Calibration Parameter:** 50.00%
Seriously Delinquent: 0%
Loss Severity: 0%

	Size	Attach	Detach	Price	Revised SSFA	NPR SSFA
Senior	82,000,000	8.89%	100.00%	100	0.56%	1.60%
Mezz	2,500,000	6.11%	8.89%	100	18.81%	18.81%
Mezz	2,000,000	3.89%	6.11%	100	65.63%	65.63%
Mezz	1,250,000	2.50%	3.89%	100	100.00%	100.00%
Mezz	1,250,000	1.11%	2.50%	100	100.00%	100.00%
Sub	1,000,000	0.00%	1.11%	100	100.00%	100.00%
	90,000,000				6.38%	7.33%

Time: Settlement + 36 months
Total Principal Received: 15,000,000 | **K_G at Origination:** 4.00%
Total Losses Realized: 0 | **Calibration Parameter:** 50.00%
Seriously Delinquent: 0%
Loss Severity: 0%

	Size	Attach	Detach	Price	Revised SSFA	NPR SSFA
Senior	77,000,000	9.41%	100.00%	100	0.56%	1.60%
Mezz	2,500,000	6.47%	9.41%	100	15.23%	15.23%
Mezz	2,000,000	4.12%	6.47%	100	55.43%	55.43%
Mezz	1,250,000	2.65%	4.12%	100	100.00%	100.00%
Mezz	1,250,000	1.18%	2.65%	100	100.00%	100.00%
Sub	1,000,000	0.00%	1.18%	100	100.00%	100.00%
	85,000,000				6.38%	7.32%

Collateral Slight Deterioration

Time: Securitization Settlement
Total Principal Received: 0 | **K_G at Origination:** 4.00%
Total Losses Realized: 0 | **Calibration Parameter:** 50.00%
Seriously Delinquent: 0%
Loss Severity: 0%

	Size	Attach	Detach	Price	Revised SSFA	NPR SSFA
Senior	92,000,000	8.00%	100.00%	100	0.56%	1.60%
Mezz	2,500,000	5.50%	8.00%	100	26.96%	26.96%
Mezz	2,000,000	3.50%	5.50%	100	85.87%	85.87%
Mezz	1,250,000	2.25%	3.50%	100	100.00%	100.00%
Mezz	1,250,000	1.00%	2.25%	100	100.00%	100.00%
Sub	1,000,000	0.00%	1.00%	100	100.00%	100.00%
	100,000,000				6.41%	7.36%

Time: Settlement + 12 months
Total Principal Received: 5,000,000 | **K_G at Origination:** 4.00%
Total Losses Realized: 0 | **Calibration Parameter:** 50.00%
Seriously Delinquent: 1%
Loss Severity: 50%

	Size	Attach	Detach	Price	Revised SSFA	NPR SSFA
Senior	87,000,000	8.42%	100.00%	100	0.56%	1.60%
Mezz	2,500,000	5.79%	8.42%	100	32.34%	22.73%
Mezz	2,000,000	3.68%	5.79%	100	94.72%	76.56%
Mezz	1,250,000	2.37%	3.68%	100	100.00%	100.00%
Mezz	1,250,000	1.05%	2.37%	100	100.00%	100.00%
Sub	1,000,000	0.00%	1.05%	100	100.00%	100.00%
	95,000,000				7.04%	7.36%

Time: Settlement + 24 months
Total Principal Received: 10,000,000 | **K_G at Origination:** 4.00%
Total Losses Realized: 0 | **Calibration Parameter:** 50.00%
Seriously Delinquent: 2%
Loss Severity: 50%

	Size	Attach	Detach	Price	Revised SSFA	NPR SSFA
Senior	82,000,000	8.89%	100.00%	100	0.56%	1.60%
Mezz	2,500,000	6.11%	8.89%	100	36.93%	18.81%
Mezz	2,000,000	3.89%	6.11%	100	100.00%	65.63%
Mezz	1,250,000	2.50%	3.89%	100	100.00%	100.00%
Mezz	1,250,000	1.11%	2.50%	100	100.00%	100.00%
Sub	1,000,000	0.00%	1.11%	100	100.00%	100.00%
	90,000,000				7.65%	7.33%

Time: Settlement + 36 months
Total Principal Received: 15,000,000 | **K_G at Origination:** 4.00%
Total Losses Realized: 0 | **Calibration Parameter:** 50.00%
Seriously Delinquent: 4%
Loss Severity: 50%

	Size	Attach	Detach	Price	Revised SSFA	NPR SSFA
Senior	77,000,000	9.41%	100.00%	100	0.95%	1.60%
Mezz	2,500,000	6.47%	9.41%	100	50.78%	15.23%
Mezz	2,000,000	4.12%	6.47%	100	100.00%	55.43%
Mezz	1,250,000	2.65%	4.12%	100	100.00%	100.00%
Mezz	1,250,000	1.18%	2.65%	100	100.00%	100.00%
Sub	1,000,000	0.00%	1.18%	100	100.00%	100.00%
	85,000,000				8.82%	7.32%

Revised SSFA Example Calculations

The examples below illustrate the SSFA calculation under Revised SSFA, compared to the SSFA calculation based on the NPR

- Examples include scenarios at various points in time and different collateral deterioration assumptions for six different securities within the same trust

Collateral Degradation

Time: Securitization Settlement
Total Principal Received: 0
Total Losses Realized: 0
Seriously Delinquent: 0%
Loss Severity: 0%
K_G at Origination: 4.00%
Calibration Parameter: 50.00%

	Size	Attach	Detach	Price	Revised SSFA	NPR SSFA
Senior	92,000,000	8.00%	100.00%	100	0.56%	1.60%
Mezz	2,500,000	5.50%	8.00%	100	26.96%	26.96%
Mezz	2,000,000	3.50%	5.50%	100	85.87%	85.87%
Mezz	1,250,000	2.25%	3.50%	100	100.00%	100.00%
Mezz	1,250,000	1.00%	2.25%	100	100.00%	100.00%
Sub	1,000,000	0.00%	1.00%	100	100.00%	100.00%
	100,000,000				6.41%	7.36%

Time: Settlement + 12 months
Total Principal Received: 5,000,000
Total Losses Realized: 1,000,000
Seriously Delinquent: 2%
Loss Severity: 50%
K_G at Origination: 4.00%
Calibration Parameter: 50.00%

	Size	Attach	Detach	Price	Revised SSFA	NPR SSFA
Senior	87,000,000	7.45%	100.00%	100	0.95%	1.60%
Mezz	2,500,000	4.79%	7.45%	100	66.28%	37.31%
Mezz	2,000,000	2.66%	4.79%	100	100.00%	100.00%
Mezz	1,250,000	1.33%	2.66%	100	100.00%	100.00%
Mezz	1,250,000	0.00%	1.33%	100	100.00%	100.00%
Sub	0	0.00%	0.00%	100	100.00%	100.00%
	94,000,000				7.43%	7.26%

Time: Settlement + 24 months
Total Principal Received: 10,000,000
Total Losses Realized: 2,000,000
Seriously Delinquent: 4%
Loss Severity: 50%
K_G at Origination: 4.00%
Calibration Parameter: 50.00%

	Size	Attach	Detach	Price	Revised SSFA	NPR SSFA
Senior	82,000,000	6.82%	100.00%	100	2.24%	8.00%
Mezz	2,500,000	3.98%	6.82%	100	100.00%	54.37%
Mezz	2,000,000	1.70%	3.98%	100	100.00%	100.00%
Mezz	1,250,000	0.28%	1.70%	100	100.00%	100.00%
Mezz	250,000	0.00%	0.28%	100	100.00%	100.00%
Sub	0	0.00%	0.00%	100	100.00%	100.00%
	88,000,000				8.91%	12.98%

Time: Settlement + 36 months
Total Principal Received: 15,000,000
Total Losses Realized: 3,000,000
Seriously Delinquent: 8%
Loss Severity: 50%
K_G at Origination: 4.00%
Calibration Parameter: 50.00%

	Size	Attach	Detach	Price	Revised SSFA	NPR SSFA
Senior	77,000,000	6.10%	100.00%	100	7.68%	8.00%
Mezz	2,500,000	3.05%	6.10%	100	100.00%	88.01%
Mezz	2,000,000	0.61%	3.05%	100	100.00%	100.00%
Mezz	500,000	0.00%	0.61%	100	100.00%	100.00%
Mezz	0	0.00%	0.00%	100	100.00%	100.00%
Sub	0	0.00%	0.00%	100	100.00%	100.00%
	82,000,000				13.31%	13.24%

Collateral Severe Degradation

Time: Securitization Settlement
Total Principal Received: 0
Total Losses Realized: 0
Seriously Delinquent: 0%
Loss Severity: 0%
K_G at Origination: 4.00%
Calibration Parameter: 50.00%

	Size	Attach	Detach	Price	Revised SSFA	NPR SSFA
Senior	92,000,000	8.00%	100.00%	100	0.56%	1.60%
Mezz	2,500,000	5.50%	8.00%	100	26.96%	26.96%
Mezz	2,000,000	3.50%	5.50%	100	85.87%	85.87%
Mezz	1,250,000	2.25%	3.50%	100	100.00%	100.00%
Mezz	1,250,000	1.00%	2.25%	100	100.00%	100.00%
Sub	1,000,000	0.00%	1.00%	100	100.00%	100.00%
	100,000,000				6.41%	7.36%

Time: Settlement + 12 months
Total Principal Received: 5,000,000
Total Losses Realized: 2,500,000
Seriously Delinquent: 4%
Loss Severity: 50%
K_G at Origination: 4.00%
Calibration Parameter: 50.00%

	Size	Attach	Detach	Price	Revised SSFA	NPR SSFA
Senior	87,000,000	5.95%	100.00%	100	2.99%	8.00%
Mezz	2,500,000	3.24%	5.95%	100	100.00%	85.65%
Mezz	2,000,000	1.08%	3.24%	100	100.00%	100.00%
Mezz	1,000,000	0.00%	1.08%	100	100.00%	100.00%
Mezz	0	0.00%	0.00%	100	100.00%	100.00%
Sub	0	0.00%	0.00%	100	100.00%	100.00%
	92,500,000				8.76%	13.08%

Time: Settlement + 24 months
Total Principal Received: 10,000,000
Total Losses Realized: 5,000,000
Seriously Delinquent: 8%
Loss Severity: 50%
K_G at Origination: 4.00%
Calibration Parameter: 50.00%

	Size	Attach	Detach	Price	Revised SSFA	NPR SSFA
Senior	82,000,000	3.53%	100.00%	100	7.68%	52.00%
Mezz	2,500,000	0.59%	3.53%	100	100.00%	100.00%
Mezz	500,000	0.00%	0.59%	100	100.00%	100.00%
Mezz	0	0.00%	0.00%	100	100.00%	100.00%
Mezz	0	0.00%	0.00%	100	100.00%	100.00%
Sub	0	0.00%	0.00%	100	100.00%	100.00%
	85,000,000				10.94%	53.69%

Time: Settlement + 36 months
Total Principal Received: 15,000,000
Total Losses Realized: 7,500,000
Seriously Delinquent: 16%
Loss Severity: 50%
K_G at Origination: 4.00%
Calibration Parameter: 50.00%

	Size	Attach	Detach	Price	Revised SSFA	NPR SSFA
Senior	77,000,000	0.65%	100.00%	100	11.36%	100.00%
Mezz	500,000	0.00%	0.65%	100	100.00%	100.00%
Mezz	0	0.00%	0.00%	100	100.00%	100.00%
Mezz	0	0.00%	0.00%	100	100.00%	100.00%
Mezz	0	0.00%	0.00%	100	100.00%	100.00%
Sub	0	0.00%	0.00%	100	100.00%	100.00%
	77,500,000				11.93%	100.00%

Revised SSFA Example Calculations

The examples below illustrate the SSFA calculation under Revised SSFA, compared to the SSFA calculation based on the NPR

- Examples include scenarios at various points in time, different collateral deterioration assumptions, and with security markdowns for six different securities within the same trust

Collateral Severe Degradation w/ Price Markdowns

Time:	Securitization Settlement			
Total Principal Received:	0	**K_G at Origination:**	4.00%	
Total Losses Realized:	0	**Calibration Parameter:**	50.00%	
Seriously Delinquent:	0%			
Loss Severity:	0%			

	Size	Attach	Detach	Price	Revised SSFA	NPR SSFA
Senior	92,000,000	8.00%	100.00%	100	0.56%	1.60%
Mezz	2,500,000	5.50%	8.00%	100	26.96%	26.96%
Mezz	2,000,000	3.50%	5.50%	100	85.87%	85.87%
Mezz	1,250,000	2.25%	3.50%	100	100.00%	100.00%
Mezz	1,250,000	1.00%	2.25%	100	100.00%	100.00%
Sub	1,000,000	0.00%	1.00%	100	100.00%	100.00%
	100,000,000				6.41%	7.36%

Time:	Settlement + 12 months			
Total Principal Received:	5,000,000	**K_G at Origination:**	4.00%	
Total Losses Realized:	2,500,000	**Calibration Parameter:**	50.00%	
Seriously Delinquent:	4%			
Loss Severity:	50%			

	Size	Attach	Detach	Price	Revised SSFA	NPR SSFA
Senior	87,000,000	5.95%	100.00%	95	0.63%	8.00%
Mezz	2,500,000	3.24%	5.95%	60	100.00%	85.65%
Mezz	2,000,000	1.08%	3.24%	40	100.00%	100.00%
Mezz	1,000,000	0.00%	1.08%	20	100.00%	100.00%
Mezz	0	0.00%	0.00%	0	100.00%	100.00%
Sub	0	0.00%	0.00%	0	100.00%	100.00%
	92,500,000				6.54%	13.08%

Time:	Settlement + 24 months			
Total Principal Received:	10,000,000	**K_G at Origination:**	4.00%	
Total Losses Realized:	5,000,000	**Calibration Parameter:**	50.00%	
Seriously Delinquent:	8%			
Loss Severity:	50%			

	Size	Attach	Detach	Price	Revised SSFA	NPR SSFA
Senior	82,000,000	3.53%	100.00%	90	1.06%	52.00%
Mezz	2,500,000	0.59%	3.53%	40	100.00%	100.00%
Mezz	500,000	0.00%	0.59%	10	100.00%	100.00%
Mezz	0	0.00%	0.00%	0	100.00%	100.00%
Mezz	0	0.00%	0.00%	0	100.00%	100.00%
Sub	0	0.00%	0.00%	0	100.00%	100.00%
	85,000,000				4.55%	53.69%

Time:	Settlement + 36 months			
Total Principal Received:	15,000,000	**K_G at Origination:**	4.00%	
Total Losses Realized:	7,500,000	**Calibration Parameter:**	50.00%	
Seriously Delinquent:	16%			
Loss Severity:	50%			

	Size	Attach	Detach	Price	Revised SSFA	NPR SSFA
Senior	77,000,000	0.65%	100.00%	80	1.43%	100.00%
Mezz	500,000	0.00%	0.65%	10	100.00%	100.00%
Mezz	0	0.00%	0.00%	0	100.00%	100.00%
Mezz	0	0.00%	0.00%	0	100.00%	100.00%
Mezz	0	0.00%	0.00%	0	100.00%	100.00%
Sub	0	0.00%	0.00%	0	100.00%	100.00%
	77,500,000				2.06%	100.00%

ANNEX G

Proposed Revisions to Section 45 of
U.S. Advanced Capital Adequacy Framework - Basel II

(e) *SFA parameters*

(1) *Amount of the underlying exposures (UE).* UE is the EAD of any underlying exposures that are wholesale and retail exposures (including the amount of any funded spread accounts, cash collateral accounts, and other similar funded credit enhancements and any additional cash flow credit enhancement) plus the amount of any underling exposures that are securitization exposures (as defined in paragraph (e) of section 42 of this appendix) plus the adjusted carrying value of any underlying exposures that are equity exposures (as defined in paragraph (b) of section 51 of this appendix).

New subsection (e)(3)(iv). In calculating Kirb, in lieu of assigning risk parameters pursuant to Section 31 of this appendix, a [bank] may assign a PD, LGD, EAD, and M to each pool of securitized exposures of a single asset class if the exposures in the pool are eligible securitized exposures. A [bank] may use net loss data with respect to the pool of securitized exposures in assigning risk parameters pursuant to this paragraph. If the [bank] can estimate ECL (but not PD or LGD) for a pool of eligible securitized exposures, the [bank] must assume that (A) the LGD of the pool equals 100 percent or such lesser percentage determined by the [bank] for the relevant asset class using a methodology for exposures of such asset type that has been approved by the [AGENCY] for use by the [bank] generally with respect to exposures of the relevant asset class and obligor type and (B) the PD of the pool equals ECL divided by the product of EAD and LGD. The estimated ECL must be calculated for the exposures without regard to any assumption of recourse or guarantees from the seller. A [bank] assigning risk parameters pursuant to this paragraph must review and update such risk parameters no less frequently than quarterly.

(e)(4) *Credit enhancement level (L).* (i) L is the ratio of:

(A) The sum of (i) the amount of all securitization exposures subordinated to the tranche that contains the [bank]'s securitization exposure, and (ii) the additional cash flow credit enhancement; to

(B) UE.

(ii) ~~A~~Except with respect to the carrying value discount of a [bank]'s securitization exposure and additional cash flow credit enhancement, a [bank] must determine L before considering the effects of any tranche-specific credit enhancements.

(iii) Any gain-on-sale or CEIO associated with the securitization may not be included in L.

(iv) Any reserve account funded by accumulated cash flows from the underling exposures that is subordinated to the tranche that contains the [bank]'s securitization exposure

may be included in the numerator and denominator of L to the extent cash has accumulated in the account. Unfunded reserve accounts (that is, reserve accounts that are to be funded from future cash flows from the underlying exposures) may not be included in the calculation of L except to the extent such amounts qualify as additional cash flow credit enhancement.

(v) In some cases, the purchase price or carrying value of receivables or a securitization exposure will reflect a discount that provides credit enhancement (for example, first loss protection) for all or certain tranches of the securitization. When this arises, L should be calculated inclusive of this discount ~~if the discount provides credit enhancement for the securitization exposure~~.

(e)(5) *Thickness of tranche (T).* T is the ratio of:

(i) The amount of the tranche that contains the [bank]'s securitization exposure less the amount obtained by multiplying (A) any discount reflected in the carrying value of the [bank]'s securitization exposure that provides credit enhancement for the [bank]'s securitization exposure expressed as a percentage, and (B) the size of the tranche containing the [bank]'s securitization exposure; to

(ii) UE.

New subsection (g). Additional cash flow credit enhancement. Additional cash flow credit enhancement may only be included in the calculation of the SFA risk parameters under paragraph (e) of this section if the following requirements are met:

(1) The [bank] must have received prior approval from the [AGENCY] to include additional cash flow credit enhancement in determining SFA parameters for its securitization exposures generally. To receive such approval, the [bank] must demonstrate to the [AGENCY]'s satisfaction that it has a comprehensive understanding of risk characteristics of its individual securitization exposures, whether on balance sheet or off-balance sheet, as well as the risk characteristics of the pools underlying its securitization exposures;

(2) The [bank] must be able to access performance information on the underlying pools on an on-going basis in a timely manner. Such information may include, as appropriate: exposure type; percentage of loans 30, 60 and 90 days past due; default rates; prepayment rates; loans in foreclosure; property type; occupancy; average credit score or other measures of creditworthiness; average loan to value equity; and industry and geographic diversification. For resecuritizations, the [bank] must have information not only on the underlying securitization tranches, such as the Issuer name and credit quality, but also on the characteristics and performance of the pools underlying the securitization tranches;

(3) The [bank] must have a thorough understanding of all structural features of the securitization transaction that would materially impact the performance of the [bank]'s securitization exposure, such as the contractual waterfall and waterfall-related

triggers, credit enhancements, liquidity enhancements, market value triggers, and deal-specific definitions of default;

(4) The cash flow methodology used by the [bank] in determining additional cash flow credit enhancement for the relevant asset class of eligible securitized receivables must be (A) commercially available, (B) transparent and verifiable, and (C) used by the [bank] for purposes other than the calculation of risk-based capital requirements, such as risk management or impairment analysis; and

(5) The additional cash flow credit enhancement for a securitization exposure must be based on a projection of the available cash flows for the benefit of such securitization exposure determined by undertaking the following steps:

(i) Projecting aggregate exposure principal and interest cash flows using a cash flow methodology for the relevant asset class described in paragraph (g)(4) of this section, using the assumptions used in assigning the PD, LGD, EAD and M to the underlying exposures and other inputs appropriate for the asset class, which may include default timing, recovery timing, prepayment, prepayment timing, and static pool or other historical loss data for the securitized exposures and similar exposures;

(ii) Applying such aggregate projected exposure cash flows to the securitization liability structure as detailed in the contractual waterfall set forth in the legal documents governing the securitization exposure; and

(iii) Stressing the assumptions and inputs in (i) above until the securitization exposure suffers its first one dollar of loss in (ii) above. The corresponding cumulative net losses experienced by the aggregate underlying exposures at this first one dollar of loss equals the total credit enhancement for the securitization exposure.

PROPOSED REVISIONS TO SECTION 2 OF
U.S. ADVANCED CAPITAL ADEQUACY FRAMEWORK - BASEL II

Additional cash flow credit enhancement means the amount of credit enhancement not included in the securitization exposures subordinated to the tranche that contains the [bank]'s securitization exposure determined to be available to a [bank]'s securitization exposure based upon the procedures set forth in Section 45(g)(5) of this appendix.

Eligible ~~purchased wholesale~~securitized exposure means a ~~purchased~~retail or wholesale exposure underlying a [bank]'s securitization exposure that:

(1) ~~The~~Either (x) (i) the [bank] or securitization SPE ~~purchased from an unaffiliated seller and~~ did not directly or indirectly originate or (ii) if originated by the [bank] or securitization SPE, are not serviced by either such person, or (y) the [bank] is prohibited by law or regulation from accessing the information necessary to determine the risk parameters required to calculate Kirb for the individual securitized wholesale exposures or segments of securitized retail exposures underlying the securitization exposure;

(2) Was generated on an arm's-length basis between the seller and the obligor ~~(intercompany accounts receivable and receivables subject to contra-accounts between firms that buy and sell to each other do not satisfy this criterion)~~;

(3) Provides the [bank] or securitization SPE with a claim on all proceeds from the exposure or a pro rata interest in the proceeds from the exposure; and

(4) ~~Has an M of less than one year; and~~

~~(5)~~ When consolidated by obligor, does not represent a concentrated exposure relative to the ~~portfolio of purchased wholesale~~pool of securitized exposures.

PROPOSED REVISIONS TO LGD DEFINITION IN
U.S. ADVANCED CAPITAL ADEQUACY FRAMEWORK - BASEL II

Loss given default (LGD) means:

(1) For a wholesale exposure, the greatest of:

(i) Zero;

(ii) The [bank]'s empirically based best estimate of the long-run default-weighted average economic loss, per dollar of EAD, the [bank] would expect to incur if the obligor (or a typical obligor in the loss severity grade assigned by the [bank] to the exposure) were to default within a one-year horizon over a mix of economic conditions, including economic downturn conditions; or

(iii) The [bank]'s empirically based best estimate of the economic loss, per dollar of EAD, the [bank] would expect to incur if the obligor (or a typical obligor in the loss severity grade assigned by the [bank] to the exposure) were to default within a one-year horizon during economic downturn conditions.

(2) For a segment of retail exposures, the greatest of:

(i) Zero;

(ii) The [bank]'s empirically based best estimate of the long-run default-weighted average economic loss, per dollar of EAD, the [bank] would expect to incur if the exposures in the segment were to default within a one-year horizon over a mix of economic conditions, including economic downturn conditions; or

(iii) The [bank]'s empirically based best estimate of the economic loss, per dollar of EAD, the [bank] would expect to incur if the exposures in the segment were to default within a one-year horizon during economic downturn conditions.

(3) The economic loss on an exposure in the event of default is all material credit-related losses on the exposure (including accrued but unpaid interest or fees, losses on the sale of collateral, direct workout costs, and an appropriate allocation of indirect workout costs). Where positive or negative cash flows on a wholesale exposure to a defaulted obligor or a defaulted retail exposure (including proceeds from the sale of collateral, workout costs, additional extensions of credit to facilitate repayment of the exposure, and draw-downs of unused credit lines) occur after the date of default, the economic loss must reflect the net present value of cash flows as of the default date using a discount rate appropriate to the risk of the defaulted exposure.

(4) Notwithstanding (1), (2) and (3) above, the LGD of a pool of securitized exposures for purposes of calculating Kirb as described in Section 45(e)(3)(iv) of this appendix shall be determined pursuant to such section, based on:

(i) The [bank]'s empirically based best estimate of the long-run default-weighted average economic loss, per dollar of EAD, the [bank] would expect to incur if the exposures in the pool were to default within a one-year horizon over a mix of economic conditions, including economic downturn conditions; or

(ii) The [bank]'s empirically based best estimate of the economic loss, per dollar of EAD, the [bank] would expect to incur if the exposures in the pool were to default within a one-year horizon during economic downturn conditions.

PROPOSED REVISIONS TO PD DEFINITION IN
U.S. ADVANCED CAPITAL ADEQUACY FRAMEWORK - BASEL II

Probability of default (PD) means:

(1) For a wholesale exposure to a non-defaulted obligor, the [bank]'s empirically based best estimate of the long-run average one-year default rate for the rating grade assigned by the [bank] to the obligor, capturing the average default experience for obligors in the rating grade over a mix of economic conditions (including economic downturn conditions) sufficient to provide a reasonable estimate of the average one-year default rate over the economic cycle for the rating grade.

(2) For a segment of non-defaulted retail exposures, the [bank]'s empirically based best estimate of the long-run average one-year default rate for the exposures in the segment, capturing the average default experience for exposures in the segment over a mix of economic conditions (including economic downturn conditions) sufficient to provide a reasonable estimate of the average one-year default rate over the economic cycle for the segment and adjusted upward as appropriate for segments for which seasoning effects are material. For purposes of this definition, a segment for which seasoning effects are material is a segment where there is a material relationship between the time since origination of exposures within the segment and the [bank]'s best estimate of the long-run average one-year default rate for the exposures in the segment.

(3) For a wholesale exposure to a defaulted obligor or segment of defaulted retail exposures, 100 percent.

(4) Notwithstanding (1), (2) and (3) above, the PD of a pool of securitized exposures for purposes of calculating Kirb as described in Section 45(e)(3)(iv) of this appendix shall be determined pursuant to such section based on the [bank]'s empirically based best estimate of the long-run average one-year default rate for the exposures in the pool, capturing the average default experience for exposures in the pool over a mix of economic conditions (including economic downturn conditions) sufficient to provide a reasonable estimate of the average one-year default rate over the economic cycle for the pool and adjusted upward as appropriate for pools for which seasoning effects are material.

Portfolios with limited defaults. Commenters indicated that they had experienced very few defaults for some portfolios, most notably margin loans and exposures to some sovereign issuers, which made it difficult to separately estimate PD and LGD. The agencies recognize that some portfolios have experienced very few defaults and have very low loss experiences. The absence of defaults or losses in historical data does not, however, preclude the potential for defaults or large losses to arise in future circumstances. Moreover, as discussed previously, the ability to separate EL into PD and LGD is a key component of the IRB approach.

As with the cases described above in which internal data are limited in all dimensions, external data from some related portfolios or for similar obligors may be used to estimate risk parameters that are then mapped to the low default portfolio or obligor. For example, banks could consider instances of near default or credit deterioration short of default in these low default portfolios to inform estimates of what might happen if a default were to occur. Similarly, scenario analysis that evaluates the hypothetical impact of severe market disruptions may help inform the bank's parameter estimates for margin loans. For very low-risk wholesale obligors that have publicly traded financial instruments, banks may be able to glean information about the relative values of PD and LGD from different changes in credit spreads on instruments of different maturity or from different moves in credit spreads and equity prices. In all cases, risk parameter estimates should incorporate a degree of conservatism that is appropriate for the overall rigor of the quantification process. These risk parameter estimates should be based upon default and loss proxies derived by the bank consistent with such conservatism in lieu of historical data under such circumstances.

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Probability of Default (PD)

As noted above, under the final rule, except as described further herein, a bank must assign each of its wholesale obligors to an internal rating grade and then must associate a PD with each rating grade. PD for a wholesale exposure to a non-defaulted obligor is the bank's empirically based best estimate of the long-run average one-year default rate for the rating grade assigned by the bank to the obligor, capturing the average default experience for obligors in the rating grade over a mix of economic conditions (including economic downturn conditions) sufficient to provide a reasonable estimate of the average one-year default rate over the economic cycle for the rating grade.

In addition, under the final rule, a bank must assign a PD to each segment of retail exposures. Some types of retail exposures typically display a seasoning pattern—that is, the exposures have relatively low default rates in their first year, rising default rates in the next few years, and declining default rates for the remainder of their terms. Because of the one-year IRB horizon, the proposed rule provided two different definitions of PD for a segment of non-defaulted retail exposures based on the materiality of seasoning effects for the segment or for the segment's retail exposure subcategory. Under the proposed rule, PD for a segment of non-defaulted retail exposures for which seasoning effects *were not* material, or for a segment of non-defaulted retail exposures in a retail exposure subcategory for which seasoning effects *were not* material, would be the bank's empirically based best estimate of the long-run average of one-year default rates for the exposures in the segment, capturing the average default experience for exposures in the segment over a mix of economic conditions (including economic downturn conditions) sufficient to provide a reasonable estimate of the average one-year default rate over the economic cycle for the segment. PD for a segment of non-defaulted retail exposures for which seasoning effects *were* material would be the bank's empirically based best estimate of the annualized cumulative default rate over the expected remaining life of exposures in the segment, capturing the average default experience for exposures in the segment over a mix of economic conditions (including economic downturn conditions) to provide a reasonable estimate of the average performance over the economic cycle for the segment.

Commenters objected to this treatment of retail exposures with material seasoning effects. They asserted that requiring banks to use an annualized cumulative default rate to recognize seasoning effects was too prescriptive and would preclude other reasonable approaches. The agencies believe that commenters have presented reasonable alternative approaches to recognizing the effects of seasoning in PD and are, therefore, providing additional flexibility for recognizing those effects in the final rule.

Based on comments and additional consideration, the agencies also are clarifying that a segment of retail exposures has material seasoning effects if there is a material relationship between the time since origination of exposures within the segment and the bank's best estimate of the long-

run average one-year default rate for the exposures in the segment. Moreover, because the agencies believe that the IRB approach must, at a minimum, require banks to hold appropriate amounts of risk-based capital to address credit risks over a one-year horizon, the final rule's incorporation of seasoning effects is explicitly one-directional. Specifically, a bank must increase PDs above the best estimate of the long-run average one-year default rate for segments of unseasoned retail exposures, but may not decrease PD below the best estimate of the long-run average one-year default rate for a segment of retail exposures that the bank estimates will have lower PDs in future years due to seasoning.

The final rule defines PD for a segment of non-defaulted retail exposures as the bank's empirically based best estimate of the long-run average one-year default rate for the exposures in the segment, capturing the average default experience for exposures in the segment over a mix of economic conditions (including economic downturn conditions) sufficient to provide a reasonable estimate of the average one-year default rate over the economic cycle for the segment and adjusted upward as appropriate for segments for which seasoning effects are material. If a bank does not adjust PD to reflect seasoning effects for a segment of exposures, it should be able to demonstrate to its primary Federal supervisor, using empirical analysis, why seasoning effects are not material or why adjustment is not relevant for the segment.

For wholesale exposures to defaulted obligors and for segments of defaulted retail exposures, PD is 100 percent.

Loss Given Default (LGD)

Under the proposed rule, except as described further herein, a bank would directly estimate an ELGD and LGD risk parameter for each wholesale exposure or would assign each wholesale exposure to an expected loss severity grade and a downturn loss severity grade, estimate an ELGD risk parameter for each expected loss severity grade, and estimate an LGD risk parameter for each downturn loss severity grade. In addition, a bank would estimate an ELGD and LGD risk parameter for each segment of retail exposures.

Expected Loss Given Default (ELGD)

The proposed rule defined the ELGD of a wholesale exposure as the bank's empirically based best estimate of the default-weighted average economic loss per dollar of EAD the bank expected to incur in the event that the obligor of the exposure (or a typical obligor in the loss severity grade assigned by the bank to the exposure) defaulted within a one-year horizon.[31] The proposed rule defined ELGD for a segment of retail exposures as the bank's empirically based best estimate of the default-weighted average economic loss per dollar of EAD the bank expected to incur on exposures in the segment that default within a one-year horizon. ELGD estimates would incorporate a mix of economic conditions (including economic downturn conditions). ELGD had four functions in the proposed rule—as a component of the calculation of ECL in the numerator of the risk based capital ratios; in the EL component of the IRB risk-based capital formulas; as a

[31] Under the proposal, ELGD was not the statistical expected value of LGD.

floor on the value of the LGD risk parameter; and as an input into the supervisory mapping function.

Many commenters objected to the proposed rule's requirement for banks to estimate ELGD for each wholesale exposure and retail segment, noting that ELGD estimation is not required under the New Accord. Commenters asserted that requiring ELGD estimation would create a competitive disadvantage by creating additional systems, compliance, calculation, and reporting burden for those banks subject to the U.S. rule, many of which have already substantially developed their systems based on the New Accord. They also maintained that it would decrease the comparability of U.S. banks' capital requirements and public disclosures relative to those of foreign banking organizations applying the advanced approaches. Several commenters also contended that defining ECL in terms of ELGD instead of LGD raised tier 1 risk based capital requirements for U.S. banks compared to foreign banks using the New Accord's LGD-based ECL definition.

The agencies have concluded that the regulatory burden and potential competitive inequities identified by commenters outweigh the supervisory benefits of the proposed ELGD risk parameter, and are, therefore, not including it in the final rule. Instead, consistent with the New Accord, a bank must use LGD for the calculation of ECL and the EL component of the IRB risk based capital formulas. Because the proposed ELGD risk parameter was equal to or less than LGD, this change generally will have the effect of decreasing both the numerator and denominator of the risk-based capital ratios.

Consistent with the New Accord, under the final rule, the LGD of a wholesale exposure or retail segment must not be less than the bank's empirically based best estimate of the long-run default-weighted average economic loss, per dollar of EAD, the bank would expect to incur if the obligor (or a typical obligor in the loss severity grade assigned by the bank to the exposure or segment) were to default within a one-year horizon over a mix of economic conditions, including economic downturn conditions. The final rule also specifies that LGD may not be less than zero. The implications of eliminating the ELGD risk parameter for the supervisory mapping function are discussed below.

PD and LGD of Certain Securitization Exposures Where Supervisory Formula Approach is Used

In calculating Kirb, banks using the supervisory formula approach to calculate capital may assign a PD and LGD to securitized exposures of the same asset class on a pool-wide basis with respect to securitization exposures where the underlying securitized exposures consist of eligible securitized exposures. The agencies recognize that banks ordinarily do not possess the information necessary to assign a PD and LGD to individual wholesale exposures or segments of retail exposures with respect to securitization exposures where the underlying securitized exposures were not originated by the bank or, if originated by the bank, are not serviced by the bank. A bank may assign such risk parameters using net loss data for the pool of securitized exposures. Banks using this method for assigning PD and LGD must review and update such risk parameters no less frequently than quarterly.

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4. SUPERVISORY FORMULA APPROACH (SFA)

Inputs to the SFA Formula

Consistent with the proposal, the final rule defines the seven inputs into the SFA formula as follows: (i) *Amount of the underlying exposures (UE).* This input (measured in dollars) is the EAD of any underlying wholesale and retail exposures plus the amount of any underlying exposures that are securitization exposures (as defined in section 42(e) of the proposed rule) plus the adjusted carrying value of any underlying equity exposures (as defined in section 51(b) of the proposed rule). UE also includes any funded spread accounts, cash collateral accounts, and other similar funded credit enhancements and any additional cash flow credit enhancement.

(ii) *Tranche percentage (TP).* TP is the ratio of (i) the amount of the bank's securitization exposure to (ii) the amount of the securitization tranche that contains the bank's securitization exposure.

(iii) *KIRB.* KIRB is the ratio of (i) the risk-based capital requirement for the underlying exposures plus the ECL of the underlying exposures (all as determined as if the underlying exposures were directly held by the bank) to (ii) UE. The definition of KIRB includes the ECL of the underlying exposures in the numerator because if the bank held the underlying exposures on its balance sheet, the bank also would hold reserves against the exposures.

The calculation of KIRB must reflect the effects of any credit risk mitigant applied to the underlying exposures (either to an individual underlying exposure, a group of underlying exposures, or to the entire pool of underlying exposures). In addition, all assets related to the securitization must be treated as underlying exposures for purposes of the SFA, including assets in a reserve account (such as a cash collateral account).

In practice, a bank's ability to calculate KIRB will often determine whether it can use the SFA or whether it must instead deduct an unrated securitization exposure from total capital. As noted above, there is a need for flexibility when the estimation of KIRB is constrained by data shortcomings, such as when the bank holding the securitization exposure is not the originator or the servicer of the underlying assets. The final rule clarifies that the simplified approach for eligible purchased wholesale exposures (Section 31) may be used for calculating KIRB.

To reduce the operational burden of estimating KIRB, several commenters urged the agencies to develop a simple look-through approach such that when all of the assets held by the SPE are externally rated, KIRB could be determined directly from the external ratings of theses assets. The agencies believe that a look-through approach for estimating KIRB would be inconsistent with the New Accord and would increase the potential for capital arbitrage. The

agencies note that several simplified methods for estimating risk weighted assets for the underlying exposures for the purposes of computing KIRB are provided in other parts of the framework. For example, the simplified approach for eligible purchased wholesale exposures in section 31 may be available when a bank can estimate risk parameters for segments of underlying wholesale exposures but not for each of the individual exposures. ~~If the assets held by the SPE are securitization exposures with external ratings, the RBA would be used to determine risk-weighted assets for the underlying exposures based on these ratings.~~ If the assets held by the SPE represent shares in an investment company (that is, unleveraged, pro rata ownership interests in a pool of financial assets), the bank may be eligible to determine risk-weighted assets for the underlying exposures using the Alternative Modified Look-Through Approach of Section 54 (d) based on investment limits specified in the program's prospectus or similar documentation.

In addition, in calculating Kirb, a bank may elect to use a top down approach for certain securitized exposures. This approach may be used for retail and wholesale exposures underlying securitization exposures that are eligible securitized exposures. Under this approach, a bank may assign a PD, LGD, EAD, and M to each pool of eligible securitized receivables that are of a single asset class. A bank may assign such risk parameters using net loss data for the pool of securitized receivables. A bank assigning risk parameters using this approach must review and update such risk parameters no less frequently than quarterly. To be an eligible securitized exposure, several criteria must be met:

- Either (i) the securitized exposure must not have been originated by the bank or securitization SPE or, if originated by the bank or securitization SPE, are not serviced by such person or (ii) the bank is prohibited by law or regulation from accessing the information necessary to determine the risk parameters required to calculate Kirb for the individual securitized wholesale exposures or segments of securitized retail exposures underlying the securitization exposure;

- The securitized exposure must be generated on an arm's-length basis between the seller and the obligor;

- The bank must have a claim on all proceeds from the exposure or a pro rata interest in the proceeds; and

- The securitized exposure must, when consolidated by obligor, not represent a concentrated exposure relative to the pool of securitized exposures.

(iv) *Credit enhancement level (L).* L is the ratio of (i) the sum of (A) the amount of all securitization exposures subordinated to the securitization tranche that contains the bank's securitization exposure and (B) additional cash flow credit enhancement (provided that the requirements discussed further below are meet with respect to such additional cash flow credit enhancement), to (ii) UE. Banks must determine L before considering the effects of any tranche-specific credit enhancements (such as third-party guarantees that benefit only a single tranche) except with respect to additional cash flow credit and carrying value discount of a securitization

tranche. Any after-tax gain-on- sale or CEIOs associated with the securitization may not be included in L.

Any reserve account funded by accumulated cash flows from the underlying exposures that is subordinated to the tranche that contains the bank's securitization exposure may be included in the numerator and denominator of L to the extent cash has accumulated in the account. Unfunded reserve accounts (reserve accounts that are to be funded from future cash flows from the underlying exposures) may not be included in the calculation of L except to the extent that such amounts qualify as additional cash flow credit enhancement.

In some cases, the purchase price or carrying value of receivables or a securitization exposure will reflect a discount that provides credit enhancement (for example, first loss protection) for all or certain tranches. When this arises, L should be calculated inclusive of this discount ~~if the discount provides credit enhancement for the securitization exposure~~.

(v) *Thickness of tranche (T).* T is the ratio of (i) the size of the tranche that contains the bank's securitization exposure less the amount obtained by multiplying (x) the discount reflected in the carrying value of the bank's securitization exposure that provides credit enhancement for that securitization exposure expressed as a percentage and (y) the size of the tranche containing the bank's securitization exposure, to (ii) UE.

Inclusion of Additional Cash Flow Credit Enhancement

Additional cash flow credit enhancement is the amount of credit enhancement not included in the securitization exposures subordinated to the tranche that contains the bank's securitization exposure determined to be available to a bank's securitization exposure based upon the procedures described further below.

Additional cash flow credit enhancement may only be included in the calculation of the SFA risk parameters if the following requirements are met:

(1) The bank must have received prior approval from its primary Federal Supervisor to include additional cash flow credit enhancement in determining SFA parameters for its securitization exposures generally. To receive such approval, the bank must demonstrate to the satisfaction of its primary Federal Supervisor that it has a comprehensive understanding of risk characteristics of its individual securitization exposures, whether on balance sheet or off-balance sheet, as well as the risk characteristics of the pools underlying its securitization exposures;

(2) The bank must be able to access performance information on the underlying pools on an on-going basis in a timely manner. For resecuritizations, the bank must have information not only on the underlying securitization tranches, such as the Issuer name and credit quality, but also on the characteristics and performance of the pools underlying the securitization tranches;

(3) The bank must have a thorough understanding of all structural features of the securitization transaction that would materially impact the performance of the bank's securitization exposure, such as the contractual waterfall and waterfall-related triggers, credit enhancements, liquidity enhancements, market value triggers, and deal-specific definitions of default;

(4) The cash flow methodology used by the bank in determining additional cash flow credit enhancement for the relevant asset class of eligible securitized exposures must be (A) commercially available, (B) transparent and verifiable, and (C) used by the bank for purposes other than the calculation of risk-based capital requirements, such as risk management or impairment analysis; and

(5) The additional cash flow credit enhancement for a securitization exposure must be based on a projection of the available cash flows for the benefit of such securitization exposure determined by undertaking the following steps:

(i) Projecting aggregate exposure principal and interest cash flows using a cash flow methodology for the relevant asset class, using the assumptions used in assigning the PD, LGD, EAD and M to the underlying exposures and other inputs appropriate for the asset class, which may include default timing, recovery timing, prepayment, prepayment timing, and static pool or other historical loss data for the securitized exposures and similar exposures;

(ii) Using such aggregate projected exposure cash flows to the securitization liability structure as detailed in the contractual waterfall set forth in the legal documents governing the securitization exposure; and

(iii) Stressing the assumptions and inputs in (i) above until the securitization exposure suffers its first one dollar of loss in (ii) above. The corresponding cumulative net losses experienced by the aggregate underlying exposures at this first one dollar of loss equals the total credit enhancement for the securitization exposure.