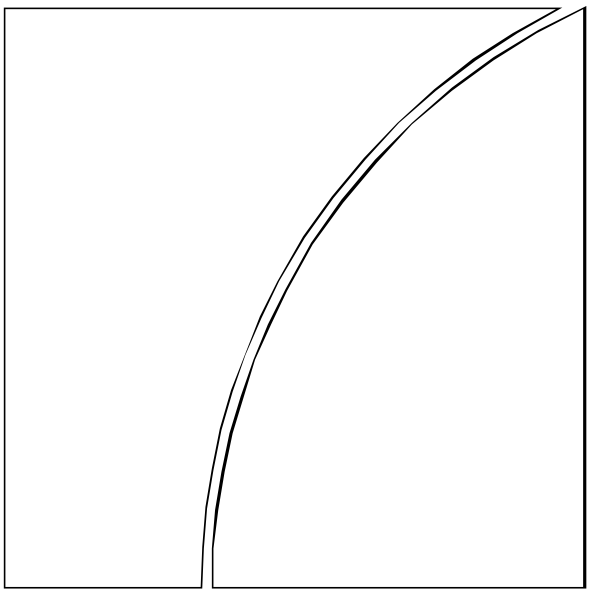
Basel Committee
on Banking Supervision



Consultative Document

Asset Securitisation

Supporting Document
to the New Basel Capital Accord

Issued for comment by 31 May 2001

January 2001

C E n a

Table of Contents

Overview

1. In view of the vast developments that have occurred in financial markets since the introduction of the 1988 Basel Accord, the Committee recognises the importance in developing a comprehensive capital framework for asset securitisation, including traditional forms as well as synthetic forms of securitisation. Within the meaning of the proposed rules, traditional securitisation involves the legal or economic transfer of assets or obligations to a third party that issues asset-backed securities (ABS) that are claims against specific asset pools. Synthetic securitisation refers to structured transactions in which banks use credit derivatives to transfer the credit risk of a specified pool of assets to third parties. However, while pursuing broadly similar economic objectives, these types of securitisations differ in many respects, such that the treatment of the explicit risks associated with them requires that they be discussed separately in Sections I and II, respectively. The Committee has also considered and continues to study implicit and residual risks as outlined in Section III. Finally, the Committee has set out disclosure requirements in order for banks to gain capital relief from securitisation, which are described in Section IV.

I. The treatment of explicit risks associated with traditional securitisation

2. The securitisation process is complex and involves banks playing a wide range of roles. Banks may act as the originator of the assets to be transferred, as the servicing agent to the securitised assets, or as sponsors or managers to securitisation programs that securitise third party assets. In addition, banks may act as a trustee for third-party securitisations, provide credit enhancement or liquidity facilities, act as a swap counterparty, underwrite or place the ABS, or invest in the securities.

3. Banks that securitise assets are able to accomplish several objectives. First, in selling or otherwise transferring, rather than holding, the originated assets, banks are able to 1) reduce their regulatory capital requirements; 2) obtain an additional source of funding, generally at a lower cost; 3) enhance financial ratios; and 4) manage their portfolio risk, e.g. reduce large exposures or sectoral concentrations. As investors, banks are able to diversify their portfolios by acquiring different asset types from different geographic areas.

4. While benefits accrue to banks that engage in securitisation activities, these activities have the potential of increasing the overall risk profile of the bank if they are not carried out in a prudent manner. Generally, the risk exposures that banks encounter in securitisation are identical to those that they face in traditional lending. These involve credit risk, concentration risk, operational risk, liquidity risk, interest rate risk (including prepayment risk), and reputational risk. However, since securitisation unbundles the traditional lending function into several limited roles, such as originator, servicer, sponsor, credit enhancer, liquidity provider, swap counterparty, underwriter, trustee, and investor, these types of risks may be less obvious and more complex than when encountered in the traditional lending process. Accordingly, supervisors should assess whether banks fully understand and adequately manage the full range of the risks involved in securitisation activities.

5. In the June 1999 consultative paper, *A New Capital Adequacy Framework*,[1] the Committee put forth several proposals to base the regulatory capital requirement for ABS on their relative riskiness by using credit ratings from external credit assessment firms (see Annex 2, paragraphs 33-36 of the First Consultative Paper). In addition, the First Consultative Paper proposed that in the case of securitisations involving revolving credits, e.g. credit card receivables that pose special problems in the opinion of the national supervisor, the off-balance sheet securitised receivables could be converted, at the discretion of the national supervisory authorities, to a credit equivalent amount at 20% and risk weighted based on the obligor's weighting (Annex 2, paragraph 36).

6. The Committee, working under the assumption that capital requirements are not the only way to address risks that arise from securitisation activities, initiated further work to explore the possibility of harmonising operational requirements for originating banks. In addition, the Committee explored the need for a special treatment of "unrated securitisations" and reviewed the treatment of revolving securitisation structures.

7. The following proposals for the treatment of securitisation are discussed first in the context of the standardised approach, then in the context of an internal ratings-based approach.

A. The standardised approach

8. The discussion of the framework under the standardised approach focuses first on originating banks, then on investing banks and finally on sponsoring banks in conduit programs.

1. The treatment for originating banks

9. In developing the securitisation proposals for the First Consultative Paper, the Committee, on the basis of a survey it had conducted, identified the regulatory operational constraints or limitations that certain countries impose on their banks' securitisation activities. The intention of these restrictions is to ensure a "clean break" between the bank originating assets and the securitisation transaction itself. The clean break approach establishes regulatory requirements regarding the transfer of assets from the originating bank and limits the roles that originating banks are permitted to perform in an attempt to separate the seller legally and economically from the securitised assets. Such requirements also are intended to minimise the reputational risk of the bank sponsoring or otherwise establishing a securitisation structure. For instance, originators of assets in certain countries may not provide liquidity facilities (also known as "servicer cash advances") to their securitisations or use the name of the bank in identifying the securitisation.

10. In some countries, such explicit regulatory constraints are minimal because the private sector (e.g. the accounting industry and the credit rating agencies) has, in effect, established requirements that are similar to many of the regulatory "clean break" constraints imposed by some supervisors.

11. From the comprehensive array of operational constraints, the Committee sought to determine if it could create a set of minimum standards to be incorporated into the First Pillar. After studying the issue, the Committee believes that common application of certain

---

1 Hereinafter referred to as the "First Consultative Paper".

basic criteria with respect to the transfer of assets from an originating bank to the securitisation transaction is achievable.

(a) Minimum operational requirements for achieving a clean break

12. The Committee is proposing that certain minimum criteria be met before a bank can remove securitised assets from the calculation of its risk-based capital ratio.

13. In order for an originating bank to remove a pool of securitised assets from its balance sheet for purposes of calculating risk-based capital, the bank must transfer the assets legally or economically via a true sale, e.g. novation, assignment, declaration of trust, or subparticipation. More specifically, a clean break has occurred only if:

(a) The transferred assets have been legally isolated from the transferor; that is, the assets are put beyond the reach of the transferor and its creditors, even in bankruptcy or receivership. This must be supported by a legal opinion;

(b) The transferee is a qualifying[2] special-purpose vehicle (SPV) and the holders of the beneficial interests in that entity have the right to pledge or exchange those interests; and

(c) The transferor does not maintain effective or indirect control over the transferred assets.[3]

Clean-up calls[4] should represent a relatively small percentage of the overall issuance of securities backed by the securitised assets. If such call arrangements are not a relatively small percentage of the total security issuance or if the sponsoring bank wishes to exercise the clean-up call at a level greater than the pre-established level, then the bank should consult with its national supervisor prior to exercising the call.

14. If the minimum requirements described above are not met, then the securitised assets must remain in the originating bank's risk-weighted assets for purposes of calculating its risk-based capital ratios – even if the transaction otherwise would be treated as a "true sale" under the home country's accounting or legal systems.

(b) Minimum capital requirements for credit enhancements

15. Banks acting as originators may continue to be involved in a securitisation transaction as loan servicers (or servicing agents) and providers of credit enhancement. In order for the risk of association to be limited, the enhancement must only be provided at the outset of the scheme. Originators and loan servicers that provide credit enhancement to a securitisation transaction must deduct the full amount of the enhancement from capital, taking into account the risk-based capital charge that would have been assessed if the assets were held on the balance sheet (see also paragraph 27). Subject to national

---

2 As defined by national accounting standards or legal frameworks.

3 A transferor has maintained effective control over the transferred assets if the transferor is able to repurchase from the transferee the assets to realise their benefits **and** is obligated to retain the risk of the assets. For purposes of determining whether a clean break has been made, the transferor's retention of servicing rights to the asset does not necessarily constitute indirect control of the asset.

4 A clean-up call is an option held by the servicer, which may also be the transferor, to purchase previously transferred assets when the amount of outstanding assets falls to a level at which the cost of servicing those assets becomes burdensome.

discretion, there may be additional requirements that a credit enhancement must meet to be accorded this treatment. Otherwise, the bank providing the enhancement may not have achieved a clean break and, as such, would not be permitted to remove the assets from the calculation of its risk-based capital ratios. Credit enhancement can take the form of servicing fees. In jurisdictions where servicing fees are capitalised and reported as an on balance sheet asset, any portion of these servicing assets functioning as credit enhancements should be deducted as well for capital purposes.[5]

16. Subject to national discretion, a second loss credit enhancement may be treated as a direct credit substitute if there is significant first-loss protection. Such prior loss protection must be provided by a third party and may elevate the credit quality of the second-loss enhancement to an investment grade level. In this case, capital would be assessed against the face amount of the second loss enhancement. Alternatively, a second-loss credit enhancement may require a deduction from capital.

17. Generally, apart from contractual provisions for providing short-term liquidity, originators or loan servicers may not provide "cash advances" or liquidity facilities to a securitisation transaction to cover short-term deficiencies in cash flow since this would be considered the equivalent of providing funding or credit enhancement. As a result, the clean break criteria will not have been met and the securitised assets must remain on the balance sheet. However, subject to national discretion and if contractually provided for, loan servicers may advance cash to ensure an uninterrupted flow of payments to investors so long as the servicer is entitled to reimbursement for any advances. Reimbursement includes repayment from subsequent collections, as well as repayment from the available credit enhancements. The payment to any investors from the cash flows stemming from the underlying asset pool and the credit enhancement must be subordinated to the reimbursement of the cash advance. Cash advances that, based on these conditions, involve very low credit risk are determined to be primarily liquidity enhancements and may be treated as commitments for capital purposes that are converted to an on-balance-sheet equivalent at 20% and generally risk-weighted at 100%. The conversion factor should be applied to either the fixed notional amount of the facility or, if no amount is set, the entire asset pool size.

(c) Minimum operational requirements for revolving securitisations with early amortisation features

18. The securitisation process is complex and, in the view of some supervisors, adhering to the minimum criteria does not necessarily achieve a "clean break" from the securitised assets. When assets are securitised, the extent to which the originating banking organisation transfers the risks associated with the assets depends on the structure of the securitisation and the type of assets involved. For example, the amount of risk that is transferred from a banking organisation securitising assets is limited for most securitisations involving loans drawn under commitments to lend, i.e. revolving credits.[6] Specifically, this includes, but may not be limited to, credit card securitisations as well as commercial loans drawn down under long-term commitments that are securitised as collateralised loan obligations (CLOs). In an attempt to mitigate the risks, some supervisors impose additional regulatory requirements that place constraints upon the structure of such a securitisation to

---

[5] Servicing assets that are not credit enhancements should be assigned the appropriate risk weight.

[6] The term revolving credits refers to loan facilities that permit borrowers to vary the drawn amount within an agreed limit. The amount of monthly payments may be at the borrower's discretion subject in some cases to a minimum amount per payment period, or by fixed schedule.

limit the roles that a sponsoring and originating bank may perform with regard to revolving credit securitisation.

19. Most revolving credit securitisations contain early amortisation provisions that are designed to force an early wind-down of the securitisation program if the credit quality of the underlying asset pool deteriorates significantly, e.g. an economic trigger.[7] In some jurisdictions, early amortisation features ensure that investors will be repaid before being subject to any risk of significant credit losses. For example, if a securitised asset pool begins to experience credit deterioration to the point where the early amortisation feature is triggered, then the ABS held by investors will begin to pay down. This occurs because, after an early amortisation feature is triggered, new receivables that are generated are retained on the sponsoring institution's balance sheet.

20. Early amortisation features raise several distinct concerns about risks to the originating banking organisation that sells the revolving receivables. First, early amortisation provisions require the originating institution to fund on-balance sheet newly generated receivables at a time when the credit quality of the asset pool is deteriorating. In addition, some regimes permit rapid early amortisation, which results in the originator's interest in the securitised assets effectively being subordinated to the interests of the investors by the payment allocation formula. If rapid amortisation is permitted, the investors effectively get paid out first, which may result in the originator's interest absorbing a disproportionate share of credit losses, depending upon the severity of losses and length of time the losses continue. However, in some jurisdictions, the prohibition on rapid amortisation may preclude the originator from being exposed to a disproportionate share of the losses. In all jurisdictions, early amortisation provisions are considered to be credit enhancements by the market. In all amortisations, the funding of newly originated assets on-balance-sheet may also create capital adequacy concerns for the originating bank, as the newly generated, on-balance-sheet receivables require risk-based capital. This may require the bank to raise new capital during a difficult time. Second, as with all amortisations, early ones may create liquidity problems for the originating banking organisation. For example, a credit card issuer must fund a steady stream of new credit card receivables. When a securitisation trust is no longer able to purchase new receivables due to early amortisation, the seller must either find an alternative buyer for the receivables. Otherwise, the receivables will accumulate on the originator's balance sheet, creating the need for another source of funding just at a time that funding costs have likely increased.

21. The two risks to the originator as discussed above might create an incentive for the originator to provide implicit recourse – credit enhancement beyond any pre-existing contractual obligation – to prevent early amortisation, regardless of pre-existing operational constraints. Although incentives to provide implicit recourse are to some extent present in other securitisations, the early amortisation feature creates additional and more direct financial incentives to prevent early amortisation through implicit recourse because of concerns about damage to the originator's reputation if one of its securitisations performs poorly.

22. There are effectively two general approaches that are currently employed by supervisors with respect to revolving securitisations.

---

[7] Early amortisation also may be triggered for non-economic reasons that are related to the securitised assets. For example, non-economic events could include the seller/servicer failing to make required deposits or payments, or the seller/servicer entering into bankruptcy or receivership.

(a) Under the first approach, in addition to the clean break criteria discussed above, supervisors also have additional operational requirements that must be met before the transferred assets can be considered to have been truly transferred thereby avoiding risk-based capital requirements.

(b) The second approach enforces essentially the same operational criteria through the supervisory process, i.e. the Second Pillar, and requirements established by the private sector.

23. The First Consultative Paper suggested that when uncontrolled early amortisation or master trust agreements pose special problems to the originating bank, the off-balance sheet securitised assets could be converted, at the discretion of the national supervisor, to a credit equivalent amount at 20% and risk weighted based on the obligor's weighting.

24. After further consideration, the Committee has confirmed the need to address these risks resulting from revolving securitisations with early amortisation provisions and concluded that a minimum capital requirement for these transactions was warranted. Therefore the Committee proposes to apply a minimum conversion factor of 10% to the notional amount of the off-balance sheet securitised asset pool in the transaction (sometimes referred to as the "investors' interest").[8] Subject to national discretion, this minimum conversion factor may be increased to a higher percentage (e.g. 20%) depending on the insufficiency of any operational requirements. Such determination will depend on numerous factors, such as provisions regarding rapid amortisation (e.g. how quickly investors may be repaid) and the permitted size of clean up calls.

2. The treatment for investing banks

25. Investing banks are usually third parties, but subject to national discretion, originating banks may occasionally invest in some of the ABS based on pools of assets they have originated. In such cases, unless specifically stated otherwise in paragraphs 15 to 17 above, the following considerations apply to the originating banks as well.

(a) Minimum capital requirements for investments in ABS

26. In setting capital requirements for banks' investments in ABS, the Committee is proposing a revision of the Accord that makes use of ratings by eligible external credit assessment institutions.[9] In this regard, the proposal is primarily addressing transactions that result in an SPV issuing paper secured by a pool of assets. The Committee notes that the securitisation market is a global market, in which a significant number of internationally active banks participate. Furthermore, asset-backed securities issued in the international market typically have a credit rating. Thus, using external credit assessments for assessing capital against risks arising from securitisation transactions would further promote the Accord's objective of ensuring competitive equality. However, beyond meeting the general eligibility criteria described in the Supporting Technical Document on the Standardised Approach, the external credit assessments institutions deemed eligible in the area of securitisation must demonstrate their expertise in this field, as may be evidenced in particular by a strong market acceptance.

---

[8] In addition, the on-balance sheet assets (the "originators' interest") will be assigned the appropriate risk weight.

[9] This capital treatment will apply regardless of the asset type that has been securitised.

27. The Committee is proposing that securitisation tranches:

- rated AAA to AA- (using, for example Standard & Poor's methodology) would be risk weighted at 20%;
- rated A+ to A- would be risk weighted at 50%;
- rated BBB+ to BBB- would be risk weighted at 100%;
- rated BB+ to BB- would be risk weighted at 150%; and
- rated B+ or below or unrated would be regarded as credit enhancement and accordingly deducted from capital.[10]

The Committee continues to study this area and may revisit these proposed risk-weights, especially for the BB- rated tranches.

28. However, not all securitisation structures are rated, such as in the case where securities are privately placed. If no specific regulation is implemented for these types of structures, the resulting unrated ABS would be assigned to the 100% risk weight category as they represent claims on private counterparties, e.g. the SPVs. In addition, in order to achieve greater risk-sensitivity, the Committee may evaluate whether supervisors could rely on a bank's internal credit ratings in order to assess the credit quality of the credit enhancement. In this respect, third-party enhancements deemed to be investment grade might be treated as a direct credit substitute and risk weighted at 100%. Third-party enhancements deemed to be below investment grade would be treated as credit enhancement and deducted from capital.

(b) Treatment of unrated securitisations

29. In any event, the Committee believes it is appropriate to incorporate a so-called "look-through approach" in the New Capital Adequacy Framework so that senior ABS, which are part of a securitisation structure that is not rated, may be treated as indirect holdings of the underlying asset pools. The Committee proposes the following conditions that must be met in order for the senior ABS, which are part of a securitisation structure that is not rated, to be accorded the look-through treatment, i.e. to be assigned to the risk category appropriate to the underlying assets. The principal criterion for this "preferential treatment" would be to ensure that the investors are effectively exposed to the risk of the underlying asset pool and not to the issuer. This will deemed to be the case if these conditions are met:

(a) rights on the underlying assets are held either directly by investors in the ABS or on their behalf by an independent trustee (e.g. by having a first priority perfected security interest in the underlying assets) or by a mandated representative. In case of a direct claim, the holder of the securities has an undivided pro rata ownership interest in the underlying assets. In case of an indirect claim, the trust or single purpose entity (or conduit) that issues the securities has no liabilities unrelated to the issued securities;

(b) the underlying assets must be fully performing when the securities are issued;

[10] This implies that credit enhancements provided by either originators or third parties will be deducted from capital.

(c) the securities are structured such that the cash flow from the underlying assets fully meets the cash flow requirements of the securities without undue reliance on any reinvestment income; and

(d) the funds, earmarked for the investors but not yet disbursed, do not carry a material reinvestment risk.

30. Even if the above conditions are met, any mezzanine or subordinated tranches in which banks invest should still be assigned to the 100% risk category. Further, if an originator retains any subordinated ABS or a subordinated interest, such positions are considered first-loss enhancements and should be deducted from capital.

31. An underlying asset pool of an asset-backed security that qualifies for the look-through approach (as discussed above) may be composed of assets that are assigned to different risk weight categories. In such a situation, the unrated senior ABS are assigned a risk weighting according to the highest risk-weighted asset that is included in the underlying asset pool.

32. Given the fact that the assessment of the rights on the underlying assets is dependent to a high degree on the local legal framework/regulations, national supervisory authorities will be responsible for the application of the look-through criteria to structures within their jurisdiction.

3. The treatment for sponsoring banks in conduit programs

33. In certain securitisation structures, such as asset-backed commercial paper programs, a bank sponsors an SPV that purchases assets from business entities, which typically are non-banks. Sponsoring banks generally are not originators or loan servicers: this is usually the function of the various asset sellers. However, they may provide credit enhancement and liquidity facilities, manage the conduit program and place the conduit's securities into the market.

34. With regard to credit enhancements, the Committee holds to the view that a first-loss credit enhancement provided by a sponsor must be deducted from capital. If possible, second loss enhancements should be risk weighted based on their external ratings. If they are not externally rated or if the assets are in multiple buckets, they should be risk-weighted according to the highest weighting of the underlying assets for which they are providing loss protection. If sponsoring banks sell their own assets to the conduit, then they also have assumed the role of originator. Thus, in the event that sponsors/originators also provide credit enhancement to the conduit program, they must deduct the full amount of the loss protection from capital.

35. Other commitments, i.e. liquidity facilities, usually are short term and, therefore, effectively are currently not assessed a capital charge since they are converted at zero percent to an on-balance sheet credit equivalent amount as required by the 1988 Basel Accord.

36. While all commitments – even short-term commitments – have a degree of credit risk exposure, commitments that provide liquidity may be structured so that they also provide credit protection to investors in the asset-backed paper. As a result, the current capital treatment accorded to commitments may not be appropriate. Credit protection may be extended in several ways. For example, the liquidity facility may be designed as an agreement to purchase specific pools of assets from an asset-backed commercial paper (ABCP) conduit when the conduit is in need of liquidity because it is unable to roll-over outstanding commercial paper. Under such an arrangement, if the liquidity facility purchases

at par assets that have defaulted, then the facility not only provides liquidity against market disruption but also credit protection to the commercial paper investors.

37. However, it is not always clear whether a particular liquidity facility is acting as a credit enhancement (i.e. a direct credit substitute or a guarantee), even though it may expose the extending bank to credit risk. There is a continuum between liquidity facilities and credit enhancements where the degree of credit risk in the transaction increases as one moves towards the credit enhancement end of the spectrum. The difficulty lies in determining when a liquidity facility has moved beyond the point where it ceases to be primarily for liquidity and functions more as a credit enhancement.

38. In general, a liquidity facility enables an ABCP conduit to ensure investors of timely payments on the issued ABS by smoothing timing differences in the payment of interest and principal on the pooled assets or to ensure payments in the event of market disruptions. Liquidity facilities typically are provided to amortising securitisations, such as residential and commercial mortgage-backed securities, and ongoing ABCP conduits.

(a) If the loan servicer reasonably expects to be repaid, cash advances may be made by the servicer/originator to securitisation transactions in order to ensure an uninterrupted flow of payments to investors or the timely collection of the securitised assets. Such advances are reimbursed from subsequent collections or in the form of a general claim on the party (i.e. credit enhancer) obligated to reimburse the servicer, and are not subordinated to other claims on the cash flows from the underlying cash flows or the credit enhancement.

(b) Liquidity support to ABCP conduits generally takes one of the two following forms:

(i) *Backstop Line or Loan Agreement* – When a draw under the facility is required, the bank lends to the ABCP conduit and receives as collateral the cash flow of the underlying asset pools.

(ii) *Asset Purchase Agreement* – When a draw under the facility is required, instead of extending a loan, the bank purchases a specific underlying pool of assets from the ABCP conduit. Assets that are past due 90 days or more or that have defaulted are not purchased. The liquidity provider is repaid from the cash flow on the purchased assets. In some instances, however, the assets may be resold to the conduit when it is able to obtain funding from the market.

39. Each deal or purchase of a specific asset pool from a third-party seller by an ABCP conduit is structured in a manner similar to a securitisation transaction and generally places the sponsoring bank in an investment grade position. ABCP conduits typically have well-developed credit and investment policies to manage liquidity and control the size, quality, and diversity of sellers and obligors that participate in the program.

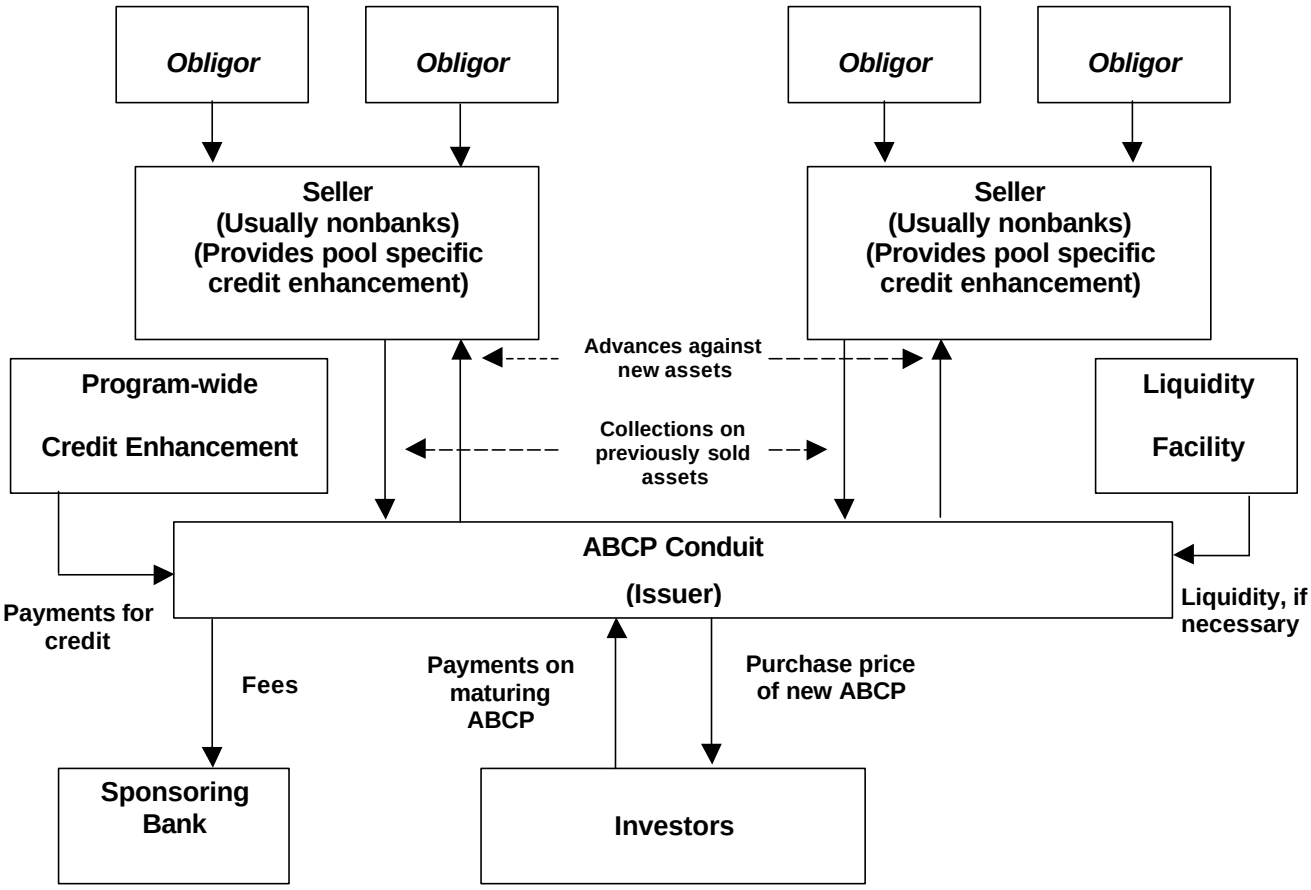
40. Usually, ABCP conduits have two levels of credit protection. The first is pool-specific reserves established by the selling organisation, e.g. overcollateralisation, or recourse back to the seller. The pool-specific enhancement generally covers defaults and absorbs subsequent credit losses, as well as dilution of assets. Each asset pool that the conduit acquires must be structured to the credit quality level consistent with the program's rating. This enhancement only covers defaults on a specific asset pool and may not be used to absorb losses on other pools in the conduit.

41. The amount of the first-loss pool-specific enhancement for each particular pool is dependent upon the seller's risk profile and covers a multiple of historical losses and dilution. Consideration is given to the seller's quality as a servicer; obligor concentrations; the largest

obligor's credit quality; and, possibly, whether the credit enhancement is dynamic (i.e. increases as the asset pool's performance deteriorates) or static (i.e. a fixed percentage).

42. The second level of credit protection is the program-wide enhancement, which may take the form of an irrevocable loan facility, standby letter of credit, surety bond from a monoline insurer or subordinated debt. As with the pool-specific enhancements, the program-wide credit protection is sized based on a multiple of losses on the portfolio of pools in the conduit; multiple of largest seller; and, if necessary, excess over the obligor concentration limits. In addition, the rating agencies consider the stress tests performed on the conduit's portfolio when determining the appropriate amount of overall credit protection.

Structural Diagram



43. As alluded to above, liquidity banks commit to extend funds to the ABCP conduit in the event of timing mismatches or market disruptions, including an issuer's inability to roll its commercial paper to ensure the timely payment to investors. Often, a conduit will have two levels of liquidity enhancement – pool-specific and program-wide liquidity.

44. A pool specific liquidity facility is associated directly with a particular pool of assets and the related commercial paper that was issued to fund the purchase of the assets. Such an enhancement is usually provided by the sponsoring bank, which may provide approximately 80% to 90% of the conduit's specific liquidity facilities. This type of facility is not fungible and may not be used to provide liquidity support to other asset pools. Typically, liquidity banks do not fund defaulted assets, if the issuer or conduit goes into bankruptcy, or if the credit enhancement is exhausted. The credit protection is sized to cover such worst-case scenarios.

45. Typically, program-wide liquidity is provided in an amount sufficient to support 100% of the face amount of all the commercial paper that is issued by the conduit.

46. In the First Consultative Paper, the Committee proposed converting all commitments, regardless of original maturity, at 20% to on-balance sheet credit equivalent amounts. An exception would be applied to commitments that are unconditionally cancellable, or that effectively provide for automatic cancellation, due to deterioration in a borrower's creditworthiness, at any time by the bank without prior notice. In such cases, a zero capital charge would apply. For instance, a liquidity facility that can only be drawn in the event of general market disruption (i.e. paper could not be issued at any price by any issuer) could be considered unconditionally cancellable and, therefore, may qualify for a zero capital charge. Adoption of a positive, non-zero capital charge for all commitments may mitigate potential concern that liquidity facilities extended to certain securitisation transactions may be exposed to some degree of credit risk.

47. The 1988 Accord generally requires that long-term commitments (those with an original maturity over one year) be subject to a 50% conversion factor, and that short-term commitments (those with an original maturity of one year or less) or those which can be unconditionally cancelled at any time be converted at zero percent. In developing the risk-based capital framework, it was recognised that a maturity break for the credit conversion factors of loan commitments might create an incentive for banks to structure their commitments in such a manner as to avoid a capital requirement. This outcome was considered acceptable provided it led banks to genuinely reduce the duration of their commitments, and thus their potential credit risk, to a maximum of one year from the date on which the commitments were made.

48. Some supervisors have defined original maturity as, "the length of time between the date the commitment is issued and the earliest date on which 1) the banking organisation can, at its option, unconditionally (without cause) cancel the commitment and 2) the banking organisation is scheduled to (and as a normal practice actually does) review the facility to determine whether or not it should be extended." Thus, a long-term facility with a nominal maturity of over one year could be converted at zero percent, if, within the first year of the commitment, the bank performs a credit review and at that point can unconditionally cancel the commitment without cause. Commitments that meet these criteria may be considered to have an original maturity of one year or less for risk-based capital purposes.

49. Under the 1988 Accord, direct credit substitutes include those arrangements that substitute for loans, including standby letters of credit and other forms of guarantees. A broader definition, used by some supervisors, includes any irrevocable arrangements that guarantee repayment of financial obligations, including asset-backed commercial paper. Thus, any commitment (by whatever name) that involves an irrevocable obligation to make a payment to a third party in the event of a failure to repay an outstanding debt obligation is treated, for risk-based capital purposes, as a financial guarantee. Such an arrangement is converted at 100% to an on-balance sheet credit equivalent amount and assigned to the risk category appropriate to the underlying obligor, which is typically the 100% category.

50. Under the 1988 Accord, banks may have an incentive to structure embedded credit enhancements in short-term commitments or liquidity facilities in order to avoid being assessed a capital charge. While all commitments, either short-term or long-term, inherently expose the extending bank to credit risk, certain liquidity facilities may go beyond providing liquidity and cover a sufficient degree of credit risk to warrant treatment as a guarantee for capital purposes. To date, supervisors have been making this determination in a variety of ways.

51. Supervisors in certain jurisdictions have established operational requirements that must be met in order for there to be a “clean break” between an originating bank and the assets that it has sold and securitised. Under these restrictions, originating banks are prohibited from providing liquidity (or a cash advance) to one of its securitisation transactions. The rational is that the provision of a liquidity facility renders void the minimal requirements of “clean break” because, in substance, the assets return to the bank in the event of a drawing under a facility. Thus, an originating bank that provides a liquidity facility to an SPV retains an ongoing relationship with the securitised assets. In such circumstances, a bank cannot be regarded as having achieved legal isolation or having surrendered control over the assets.

52. However, supervisors in other jurisdictions believe that such cash advances are an important and well-established part of the servicing function. As long as the cash advance is isolated from the credit risk of the serviced assets it is considered a commitment.

53. More importantly, supervisors are concerned that the terms and conditions of a liquidity facility extended to an amortising securitisation or an ABCP program may be drafted so that the facility not only provides liquidity enhancement, but also credit protection. To counteract this problem, some regulatory authorities have drawn up a list of requirements that must be complied with before a facility will be recognised as being provided purely for the purposes of liquidity.

54. The Committee has endeavoured to develop a common approach for determining when commitments that are purportedly extended for purposes of liquidity are, in fact, more akin to guarantees and should be treated as such for regulatory capital. More specifically, the Committee has agreed that liquidity facilities provided by sponsors to conduit programs generally should be used to cover short-term market disruptions that prohibit the roll-over of commercial paper or issuance of notes but should not in any way constitute credit loss protection available to investors. In order to ensure that the facility is used purely for liquidity purposes, the Committee has developed the following requirements:

(a) a facility must be a separately documented agreement provided to an SPV – not to the investors – at arm’s length, on market terms, at market rates and subject to the bank's normal credit approval and review processes;

(b) the SPV must have the clear right to be able to select a third party to provide the facility;

(c) a facility must be fixed in amount and duration, with no recourse to the bank beyond the fixed contractual obligations provided for in the facility;

(d) the terms of the facility must clearly identify and limit the circumstances under which it may be drawn and, in particular, the facility must not be used to provide credit support, cover losses sustained, or act as permanent revolving funding;

(e) the drawings under the facility should not be subordinated to the interests of the noteholders and the payment of the fee for the facility should not be further subordinated or subject to a waiver or deferral; and

(f) the facility should include either a reasonable asset quality test to ensure that a drawing would not cover deteriorated or defaulted assets or a term requiring the termination or reduction of the facility for a specified decline in asset quality.

55. The Committee proposes that these facilities be converted to an on-balance sheet amount and risk-weighted based on the supervisory determination, which includes consideration of the above criteria, of whether the facility is primarily for liquidity or credit enhancement, as well as on its credit quality. Facilities that are determined to be primarily liquidity enhancements may be treated as commitments for capital purposes that are

converted at 20% and generally risk-weighted at 100%. Facilities that are determined to be primarily credit enhancements should be treated according to the risk-weighting scheme for securitisation positions as set forth in paragraph 27 above. For example, facilities determined to be credit enhancements and rated BBB, would be assigned to the 100% risk category; those rated BB would be assigned to the 150% category; and those exposures rated B+ or below or not rated would be deducted from capital.

56. As these positions are unlikely to be rated or traded, the Committee will further explore whether supervisors could rely on a bank's internal credit ratings in order to assess the credit quality of the liquidity facilities (as previously discussed in paragraph 28). For instance, facilities deemed to be investment grade could be treated as commitments and risk weighted accordingly. Facilities deemed to be below investment grade could be deducted from capital.

B. Securitisation under IRB: A Hybrid Approach

57. The Committee has developed the outline of a securitisation treatment for IRB that follows the same economic logic used for the standardised approach. At the same time, the Committee wishes to take advantage of the greater capacity for risk-sensitivity under the IRB framework. The specific mechanism depends on whether the bank in question is an issuer or an investor in securitisation tranches. The treatment described here would apply to traditional securitisation transactions under both the foundation and advanced IRB approaches.

58. The Committee will continue its work to refine the IRB treatment of securitisation during the consultative period, and to address key outstanding issues. These issues, including operating standards and the treatment to be accorded to synthetic securitisation transactions, are discussed below.

1. The treatment for issuing banks

59. For banks issuing securitisation tranches, the full amount of retained first-loss positions would be deducted from capital, regardless of the IRB capital requirement that would otherwise be assessed against the underlying pool of securitised assets.

60. The Committee is also considering whether issuing banks that retain tranches with an explicit rating from a recognised external credit assessment institution could apply an IRB capital requirement tied to that rating by mapping this assessment into the PD/LGD framework. This treatment effectively follows the approach for externally rated tranches held by an investor bank described below.

2. The treatment for investing banks

61. For *banks investing in securitisation tranches issued by other institutions*, the Committee proposes to rely primarily on ratings for such tranches provided by external credit assessment institutions (ECAIs). Specifically, the bank would treat the tranche as a single credit exposure like other exposures, and apply a capital requirement on the basis of the PD and LGD appropriate to the tranche. The appropriate PD would be that associated with the external rating on the tranche in question. This PD could be measured directly as the long-term historical overall default rate of instruments in that rating category for the ECAI in question measured with an appropriately conservative bias. Alternatively, it could be measured indirectly as the PD estimated by the bank for its own internal grade that is

"comparable" to that external rating based on a mapping analysis that is approved by supervisors. Although the Committee will continue to refine its analysis over the consultative period, it proposes for the sake of conservatism to apply a 100% LGD to such tranches. This 100% LGD would apply to both foundation and advanced-approach banks.

62. If the tranche is unrated (e.g. associated with a bilateral transaction), which can be viewed as evidence of the position's low credit quality, the investing bank would be expected to deduct the tranche from capital.

3. Issues for further work

63. The Committee is looking to several specific issue areas as it continues its work to refine this proposal. For instance, the assumption of 100% LGD is extremely conservative and does not differentiate between first-loss and more senior loss positions. Nor does it differentiate between those banks on the foundation or advanced approach for the estimation of LGD.

64. The Committee will continue to study alternative approaches, such as,

(a) the "two-legged" or "sliding-scale" approach that would require the issuing bank first to calculate the IRB capital requirement on the entire pool of securitised exposures, and then to adjust that requirement to reflect the risk that has been transferred to investors in that pool. For example, under this approach, retained first-loss positions up to an amount equal to the IRB capital requirement on the underlying pool of securitised exposures, the degree of adjustment – termed "s" – would be equal to one, which is equivalent to a deduction from capital. For that portion of the retained positions in excess of the IRB capital requirement on the underlying pool, the "s" factor could conceivably be set at less than one to reflect the transfer of some credit risk to investors in securitisation tranches. And,

(b) a broader application of a PD/LGD treatment for individual securitisation tranches that would not require these tranches to be externally rated. Among the issues that would have to be addressed is how banks or supervisors could attribute a single PD estimate to an unrated tranche in a way that could be validated.

65. In the case of investments in unrated tranches, including bilateral transactions, deduction from capital may be unwarranted. Thus, the Committee is considering to what extent an implied rating could be applied to the unrated tranche, based on the ratings of other tranches in the securitisation transaction. Such an approach would need to be implemented with considerable caution and conservatism. An additional option could require the investing bank to perform sufficient due diligence to determine the IRB capital requirement on the entire pool, and to apply the "two-legged" or sliding-scale treatment described for issuing banks above. The Committee will continue to develop and refine these options during the consultative period.

66. The Committee believes that the operating standards proposed for the revised standardised approach would also be applicable to the IRB treatment, although there may be some small number of additional considerations specific to the IRB context.

67. Complex transactions present further challenges to the simple treatment described above. In particular, capital treatment under an IRB approach for synthetic securitisations raises issues that parallel those of credit derivatives.

Specific Issues/Questions for Comment:

1. What are the industry's views on the best way forward for the development of a more risk-sensitive approach to securitisation in the IRB approach?
2. With respect to the two-legged or sliding-scale approach, what are the industry's views on possible methods for calibrating numbers for the adjustment factor consistent with less than dollar-for-dollar deduction of first-loss positions?
3. Does the differentiation in treatment on the basis of being an issuer or investor bank provide a balanced and consistent economic approach?
4. In a framework that relies on the presence of an external rating, how could PDs be attributed either by banks or supervisors to unrated securitisation tranches? Does the use of external ratings create the possibility of regulatory capital arbitrage under an IRB approach because of the potential difference between the default correlations imbedded in the IRB framework and those used by ECAIs?

II. The treatment of explicit risks associated with synthetic securitisation

68. "Synthetic securitisation" refers to structured transactions in which banks use credit derivatives to transfer the credit risk of a specified pool of assets to third parties, such as insurance companies, other banks, and unregulated entities. The transfer may be either funded, for example, by issuing credit-linked securities in tranches with various seniorities ("collateralised loan obligations" or CLOs) or unfunded, for example, using credit default swaps. Synthetic securitisation can replicate the economic risk transfer characteristics of securitisation without removing assets from the originating bank's balance sheet or recorded banking book exposures.

69. Synthetic securitisation may also be used more flexibly than traditional securitisation. For example, to transfer the **junior** (first and second loss) element of credit risk and retain a **senior** tranche; to embed extra features such as leverage or foreign currency payouts; and to package for sale the credit risk of a portfolio (or reference portfolio) not originated by the bank. Banks may also exchange the credit risk on parts of their portfolios bilaterally without any issuance of rated notes to the market. Another variant is to use credit derivatives to transfer the risk of a small number of corporate "names" (e.g. ten) rather than that of a larger portfolio.

70. Four schematic transaction types are illustrated in Annex 1:

(a) Entire notional amount of the reference portfolio is hedged;

(b) High quality, senior risk position in the reference portfolio is retained along with a first-loss position;

(c) Bilateral transactions; and

(d) Utilisation of a highly rated intermediary institution.

71. From the originators' perspective, the incentives to use such products, apart from the greater flexibility, are that they are cheaper and quicker to arrange and they side-step legal and confidentiality difficulties in transferring assets. However, certain basis risks can reduce the completeness of risk transference. These risks arise from asset mismatches

(when the underlying portfolio of assets differs somewhat from the assets referenced in the credit derivative), as well as currency and maturity mismatches, and materiality thresholds (below which a credit event is not called or no protection payment is paid out).

72. From the investors' perspective, notes can be structured to achieve a desired portfolio profile and seniority/rating. At the same time, due to confidentiality constraints for the sponsoring bank, the notes may be referenced to blind pool structures whose underlying components are not disclosed to investors. In these cases investors may know only the diversity score and average quality of the pool.

73. Synthetic securitisation is a comparatively cost-effective mechanism for repackaging credit risk portfolios in response to incentives in regulatory capital requirements. However, it should be noted that, under an internal ratings based approach, the incentive to engage in synthetic securitisations may very well be mitigated since, in theory, the regulatory capital requirements would be closer to the economic capital actually required against the risk of the reference portfolio. Given the convergence of the two capital measures, the transaction costs also tend to reduce the incentive banks have to engage in a synthetic securitisation in order to minimise their capital requirements.

74. However, small, less sophisticated banks that are not eligible for the internal ratings based approach may legitimately wish to engage in synthetic securitisations for purposes other than arbitraging the capital requirements, such as transferring large exposures. Thus, a treatment for synthetic securitisations may be needed in the standardised approach, subject to robust operational requirements.

75. The Committee intends to finalise its work on the capital requirements and the operational requirements related to synthetic securitisations in the near term. The operational requirements would be in addition to those for credit risk mitigation, which, given the nature of synthetic securitisations, are applicable to these instruments.

76. However, the Committee has already identified a number of issues that will need to be resolved in order to develop a consistent and comprehensive treatment of these synthetic securitisations, for both the standardised and internal ratings-based approaches.

A. Degree of risk transference

77. A key issue to be considered is the amount of credit risk that is transferred to third parties and whether a large degree of risk transference is necessary in order to obtain regulatory capital relief. There are three aspects to this: (i) retention of first-loss risk (ignoring senior risk); (ii) retention or repurchase of senior/mezzanine risk (ignoring first-loss risk) and (iii) the retention of first-loss and senior risk.

1. Retention of first-loss

78. Credit enhancement is a feature of both traditional and synthetic securitisations (a rating agency's requirement for investor protection). First-loss positions are usually held by the originating institution. In the context of traditional securitisations, first-loss positions generally tend to take the form of subordinated debt. In synthetic securitisations they generally take the form of a payout clause of the contract. The size of the first-loss piece is driven primarily by a combination of the ratings requirements of the originating institution and the underlying asset quality (in traditional securitisations this tends to be a multiple of expected losses). The question, therefore, arises as to whether the level of credit enhancement retained by the originating institution should be restricted to ensure a

reasonable degree of risk transference or whether the proposed capital treatment for first-loss positions (i.e. deduction from capital) negates the need for this. Factors to consider in relation to both approaches are set out below.

79. Restricting any retained first-loss to expected losses on the reference pool, which would then be deducted from capital, would ensure that there would be real risk transference in the form of unexpected losses. In addition, it is a prudent treatment for retained first-loss positions held by originators. However, such an approach would require supervisory resources and continual judgements to determine whether proposed retention corresponds to a reasonable estimate of expected losses on a number of different reference portfolios. Furthermore, it is inconsistent with the current capital treatment applicable to traditional securitisations.

80. An alternative approach would not limit the size of retained first-loss risk positions to a reasonable estimate of expected losses on a particular portfolio, i.e. such positions could be several multiples of expected losses and would require deduction of any first-loss exposures from capital. This appears to be a prudent treatment of retained first-loss positions since any potential losses are deducted up-front, it is simple to implement, and is consistent with the existing approach for traditional securitisations. However, as with traditional securitisations, there is little, if any, real risk transference in transactions structured as described.

2. Retained/repurchased senior/mezzanine risk

81. In traditional securitisation structures all of the assets' risk (above first-loss) is transferred to an SPV for onward issuance to the market. However, in synthetic securitisations, only the mezzanine risk (which could be as little as 5% or 6% of the nominal amount of the portfolio) tends to be transferred to the SPV. The senior risk is either transferred in a bilateral agreement to another bank or investment firm or retained by the originating institution. Given this structural difference, the Committee is considering whether the senior risk should be required to be transferred and the implications for the proposals on traditional securitisation.

82. The Committee discussed the principles and operational requirements which would make it acceptable for the originating bank to retain the most senior risk exposure in a synthetic structure. These principles could include: 1) that the senior risk position is of high quality, 2) that there are sufficient operational requirements to ensure that the mezzanine risk has been effectively transferred to the SPV and 3) that there is sufficient market discipline (i.e. the originator should not be able to buy back or retain any positions other than the most senior[11]) on the paper issued by the SPV. The Committee continues to explore whether these operational requirements warrant an effective transfer of risk and the question of whether these operational requirements are consistent with the clean break criteria proposed for traditional asset securitisation.

3. Retention of both first-loss and senior risk

83. The final scenario that the Committee considered in relation to the required degree of risk transference in order to obtain capital relief is whether it makes a difference if the

[11] Although some small derogation may be necessary for the purposes of market making.

originator holds both the senior risk and the first-loss risk positions. The most extreme example of this would be to effectively hold the entire portfolio with only an extremely small portion of mezzanine risk transferred to the market, e.g. $1. In this scenario, the originating bank could reduce its capital requirements significantly and still effectively maintain the same risks. The Committee is still considering a number of options, including the following:

(a) require that the retained first-loss be restricted to expected loss in order for the retained senior risk to qualify for the lower capital requirement;

(b) require a minimum percentage of the nominal amount of the portfolio to be transferred to the market (say, 10%);

(c) require a minimum transfer of risk to the market, i.e. notes issued to the market must be AAA;

(d) impose a minimum time period for which notes must be in issue prior to repurchase;

(e) do not recognise any implicit rating on retained or repurchased senior positions but apply the capital charges as set out for unrated structures in traditional asset-backed security structures.

B. Consistency with CRM

84. In addition, the Committee is considering the extent to which the treatment of synthetic securitisation should be consistent with the Credit Risk Mitigation Techniques set forth in this Second Consultative Paper. This points to a number of issues, including the treatment of collateral (asset and currency mismatch, eligibility and "w" mechanics), guarantees and credit derivatives (eligibility, substitution-plus approach and partial guarantees) and maturity mismatches.

C. Operational requirements

85. The Committee has considered a number of criteria that would need to be met in order to obtain a preferential capital charge. These would potentially consist of structural, risk management and disclosure criteria.

1. Structural criteria

86. Such criteria could include the following:

(a) Ensure the absence of any early amortisation or other credit performance contingent clauses;[12]

(b) Subject the transaction to market discipline through the issuance of a substantive amount of AAA-rated notes or securities to the capital markets;

(c) Have notes or securities rated by two rating agencies;

---

[12] An early amortisation clause may generally be defined as a feature that is designed to force a wind-down of a securitisation program and rapid repayment of principal to investors of ABS if the credit quality of the underlying asset pool deteriorates significantly.

(d) The SPV, even though highly rated, would not be considered to be an eligible guarantor that would reduce the risk weight of the portion of the reference portfolio hedged credit derivative. In order for this portion of the reference portfolio to obtain capital relief, the vehicle must pledge eligible collateral (i.e. cash or zero-weighted central government securities) to the beneficiary bank;

(e) Ensure that sponsoring banks do not reassume any credit risk from the investors through another credit derivative or any other means. The structure should not contain terms or conditions that would significantly limit the credit protection provided against the underlying assets;

(f) Credit derivative documentation should follow generally accepted market practice where possible. If there is no established market norm, documentation should be fully vetted through new product procedures. Credit events (which trigger payment under the transaction) should at a minimum include default of the underlying asset protected, or default of an obligation of the underlying name where cross reference clauses exist with the underlying asset protected. The contract should make clear which sources of public information would be used to determine the occurrence of a credit event;

(g) A legal opinion is required to ascertain that the synthetic securitisation structure works as specified to the supervisor and the market.

2. Risk management criteria

87. Beyond the above structural criteria, the Committee would seek to ensure that the originating institution has adequate capital for the credit risk of its unhedged exposures. Therefore, institutions – even those operating under the standardised approach – would be expected to have adequate systems that fully take into account the effect of such transactions on the institutions' risk profiles and capital adequacy. In particular, those systems should be capable of fully differentiating the nature and quality of the risk exposures transferred by an institution from the nature and quality of the risk exposures it retains.

3. Disclosure criteria

88. Finally, the Committee would expect originating institutions to provide adequate disclosure to the marketplace in their (semi) annual reports on the accounting, economic, and regulatory consequences of such transactions. These requirements would fall into the general framework for disclosure for securitisation.

III. Implicit and residual risks

89. The Committee recognises that even when a securitisation complies with the clean break criteria as specified in paragraph 13 above, originators may be subject to "moral" or reputational risk, thereby providing implicit support to a securitisation transaction whose underlying asset pool is experiencing credit deterioration. This implicit support is typically demonstrated by a bank's actions beyond any contractual obligations. Actions that may constitute implicit support include selling assets to a trust or SPV at a discount from book value, exchanging performing for non-performing assets or other actions that result in a significant transfer of value in response to deterioration in the credit quality of the securitised asset pool.

90. The Committee has considered the question of what constitutes an appropriate capital treatment for such implicit and residual risks, and holds to the view that the following approach should be regarded as the basis for addressing these risks. This approach would consist of applying the following measures when an institution is determined to have provided implicit recourse:

(a) If it is determined that an institution has provided implicit recourse to any portion or tranche of a securitisation that it has originated, then all of the assets associated with this structure (i.e. not only a specific tranche but *all* tranches of the structure) will be treated as if they were on the bank's balance sheet. These assets will then be risk-weighted accordingly for purposes of capital calculation. Illustrative examples of the types of additional recourse include the purchase/substitution of assets that were securitised, lending to the structure (outside of contractual provisions for providing short-term liquidity) and deferral of fee income associated with the structure.

(b) If a supervisor determines that an institution has provided implicit recourse on a second and subsequent occasion, then *all* of this institution's securitised assets – not just the structure for which implicit support was provided – will be treated as if they were on its balance sheet and risk-weighted accordingly. The bank will be prevented from gaining capital relief through the securitisation process for a period to be determined by the bank's supervisor.

(c) In both instances, a bank will disclose publicly that it was found to have provided implicit recourse and the consequences of such actions as outlined above. This disclosure will include the impact of the securitised assets reverting to the bank's balance sheet for capital calculation purposes and the potential for further supervisory action, as appropriate.

91. The Committee believes that ***at a minimum***, these measures will help address the issue of banks taking on more risk than that for which they are contractually liable. However, the Committee is conducting further work to fully assess the nature, frequency and consequences of banks providing implicit recourse. The Committee is also studying other residual risks not captured in an explicit capital charge as well as unacceptable capital arbitrage opportunities arising through the securitisation process. The results of the Committee's study in these areas may allow an assessment of an *ex ante* minimum capital charge for securitisation transactions to fully address implicit and residual risks. The Committee will also consider the possibility of measuring the amount of risk transferred by originating banks through the use of external ratings given to those tranches not retained by the originating bank. In any event, when setting such a capital charge, the Committee would ensure that it is risk-based and would take account of all other capital provided under the minimum capital requirements framework as well as the potential impact on the securitisation market.

92. This proposed treatment of implicit recourse and other residual risks would supplement the other requirements concerning securitisation, including clean break criteria, liquidity facility criteria, treatment of unrated securitisations, the deduction from capital of first-loss risk positions and the treatment for revolving securitisations with early amortisation features. The Committee recognises the value of the consultative process in developing an appropriate treatment for asset securitisation and seeks meaningful dialogue with the industry in this regard.

IV. Disclosure requirements

93. The Committee proposes that banks be required to publicly disclose certain quantitative and qualitative information in order to gain preferential capital treatment with respect to asset securitisations. The following tables outline the required disclosures that must be made by originating banks, sponsoring banks and SPVs established by banks. Many of the proposed disclosure requirements reflect the level of information currently disclosed to the market.

A. Disclosures by originators

	Disclosure	*	Rationale	Desired Location
1	Quantitative data on the • Aggregate amount of loans and commitments securitised (nominal, notional and outstanding balance) broken down into synthetic and traditional securitisation categories. • If appropriate, this should be broken down further into term and revolving assets. • Where revolving, the amount of seller interest should be disclosed. • Amount of funding provided by securitisation activity. All data should be disclosed by deal if material.	A D	Information on the amount of assets securitised would provide a bank's counterparties an indication of the level of the bank's activity in the securitisation market and the amount of risk transferred. Data on the amount of funding provided will indicate extent of reliance on securitisation activity.	Statutory Accounts
2	Asset types securitised. By deal if material	A D	Disclosure would assist in ascertaining the risk profile of the bank.	Statutory Accounts
3	Roles played by the originator in relation to its securitisation activities (e.g. servicer, provider of credit enhancement, liquidity provider, swap provider etc.)	A D	Provide information as to the extent of the links between the originator and the scheme and therefore highlight potential scope for implicit recourse.	Statutory Accounts
4	Aggregate data regarding the maximum amount of credit exposure arising from recourse/credit enhancement provided to the transactions coupled with a declaration that support is limited to these contractual obligations only. Disclose data on credit enhancement by deal if material.	A D	In order to give counterparties a true picture of a bank's risk profile, the amount of recourse/enhancements must be disclosed. A declaration regarding further support should assist in preventing further support.	Statutory Accounts
5	Aggregate date regarding the size and nature of liquidity facilities provided. Disclose by deal if material.	A D	Where a jurisdiction allows originators to provide liquidity facilities to their own securitisations, this would provide information as to the links with the scheme and also the liquidity profile of the bank.	Statutory Accounts

** A – Aggregate, D – By Deal or both*

B. Disclosures by sponsors/third parties

The following disclosures are proposed for all sponsors (and for some third parties). These disclosures are required for those securitisations where the bank has a material involvement in the transaction i.e. providing liquidity or credit enhancement. If a bank performs only roles with regard to that securitisation, those roles should be disclosed. However where a bank simply performs a non-material role, e.g. as swap counterparty, the bank is not be required to make any securitisation-specific disclosures.

	Disclosure	*	Rationale	Desired Location
1	Data regarding the maximum amount of credit exposure arising from recourse/credit enhancement provided to the transactions coupled with a declaration that enhancement is limited to the contractual amounts specified. Disclose by deal if material.	A D	In order to give counterparties a true picture of a bank's risk profile the amount of recourse/enhancements must be disclosed if sponsor wishes to provide such facilities. A declaration regarding further support should assist in preventing further support.	Statutory Accounts
2	Size and nature of liquidity facilities. By deal if appropriate.	A D	Where a bank provides liquidity facilities to commercial paper conduits, the size and nature of the commitments should be disclosed. The aim of this disclosure is to give counterparties an indication of a bank's contingent liabilities.	Statutory Accounts

** A – Aggregate, D – By Deal or both*

C. Disclosures by Issuers (i.e. SPVs)

The following disclosures are proposed for all issuers.

	Disclosure	*	Rationale	Desired Location
1	The names of all rating agencies or other sources of external assessment used for risk weighting purposes.	D	Disclosure is required to ensure that only reputable agencies (those with market credibility) are employed	Offering Circular
2	A summary of the legal structure of the transaction.	D	Where the legal structure of a transaction is transparent, the risks involved in that the transaction become clearer to investors.	Offering Circular
3	The form of transfer used, in particular any residual links to or rights held by the originator	D	The method of transfer can have an important bearing upon the risks assumed by the buyer and the seller, as different methods achieve a “cleaner break” than others.	Offering Circular
4	Asset types securitised, selection criteria and substitution criteria	D	Ensure investors understand the risk that they are undertaking	Offering Circular
5	The names of all parties participating in the structure of the transaction and their associated role including originator, servicing agent, provider of credit enhancement, provider of liquidity, swap counterparties, provider of GICs, security trustee, underwriter and marketmaker.	D	Disclosure of the parties involved in the transaction would assist the investor in assessing the robustness of the transaction.	Offering Circular
6	The amount and form, rating (where obtained) of the credit support within the transaction. With declaration that credit support is only as outlined – no further support is possible.	D	In order to assess the adequacy of expected loss cover on the portfolio, an issuer should disclose the structure of enhancements. Where enhancements are unfunded, e.g. by an insurer, the identity of the counterparty should be disclosed.	Offering Circular
7	The amount, form, rating (where obtained) and position in payment ranking of the liquidity facility (if any) supporting the transaction	D	Investors must be made aware of the size and type of facility incorporated into the transaction, so that they can assess the quality of protection in the event of market disruption. The priority of the liquidity facility in the payment waterfall must also be disclosed.	Offering Circular
8	The early amortisation triggers on the pool.		Investors should be made aware of the triggers on the pool to ensure that they understand the limit to the risk that they are accepting.	Offering Circular

** A – Aggregate, D – By Deal or both*

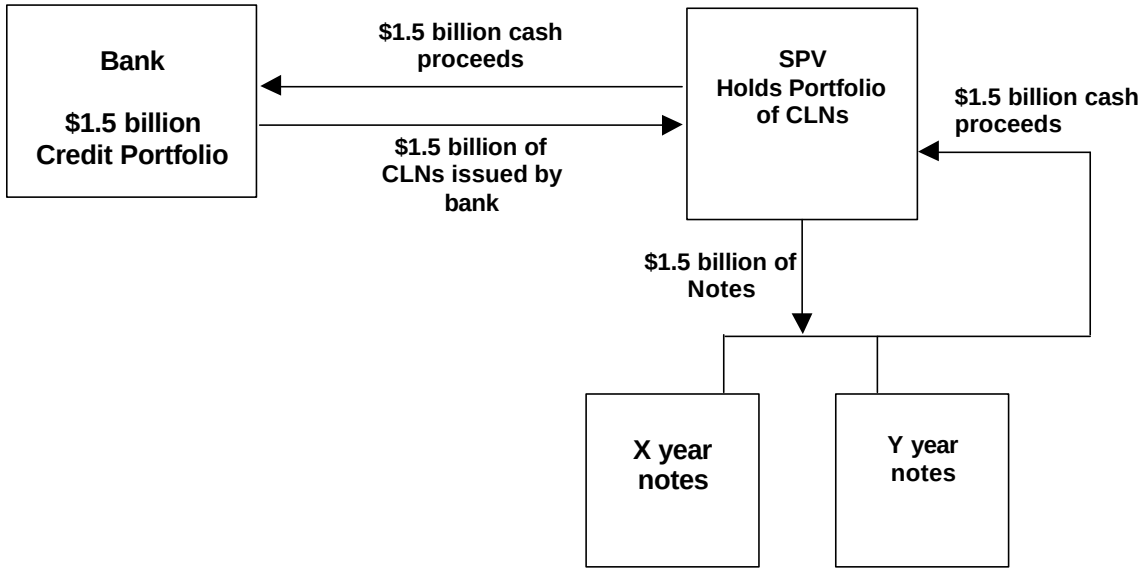
Annex 1

Synthetic securitisation examples

1. Entire notional amount of the reference portfolio is hedged

In this type of synthetic securitisation, an SPV acquires the credit risk on a reference portfolio by purchasing credit-linked notes (CLNs) issued by the sponsoring banking organisation. The SPV funds the purchase of the CLNs by issuing a series of notes in several tranches to third party investors. The investor notes are in effect collateralised by the CLNs. Each CLN represents one obligor and the bank's credit risk exposure to that obligor, which may take the form of, for example, bonds, commitments, loans, and counterparty exposures. Since the noteholders are exposed to the full amount of credit risk associated with the individual reference obligors, all of the credit risk of the reference portfolio is shifted from the sponsoring bank to the capital markets. The dollar amount of notes issued to investors equals the notional amount of the reference portfolio. In the example shown in Figure 1 below, this amount is $1.5 billion.

Figure 1



If there is a default of any obligor linked to a CLN in the SPV, the institution will call the individual note and redeem it based on the repayment terms specified in the note agreement. The term of each CLN is set such that the credit exposure to which it is linked matures prior to the maturity of the CLN. This ensures that the CLN will be in place for the full term of the exposure to which it is linked.

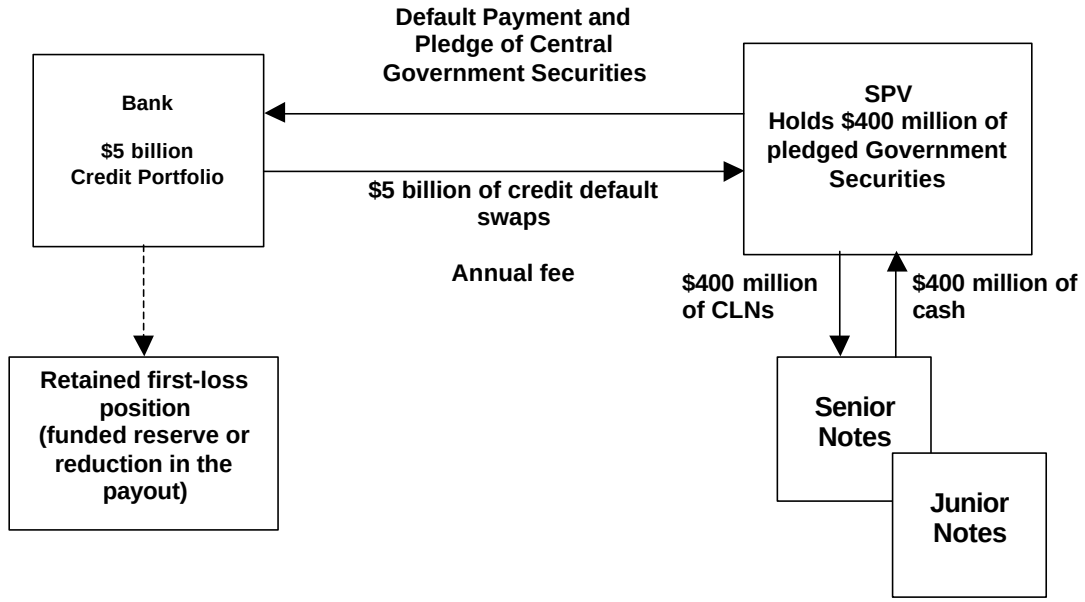
An investor in the notes issued by the SPV is exposed to the risk of default of the underlying reference assets, as well as to the risk that the sponsoring institution will not repay principal at the maturity of the notes. Because of the linkage between the credit quality of the sponsoring institution and the issued notes, a downgrade of the sponsor's credit rating most likely will result in the notes also being downgraded.

2. High quality, senior risk position in the reference portfolio is retained including a small first-loss position equal to expected losses

In some recent synthetic CLOs, the sponsoring banking organisation uses a combination of credit default swaps and CLNs to essentially transfer to the capital markets the credit risk of a designated portfolio of the organisation's credit exposures. In this structure, the sponsoring banking organisation purchases default protection from an SPV for a specifically identified portfolio of banking book credit exposures, which may include letters of credit and loan commitments. The credit risk on the identified reference portfolio (which continues to remain in the sponsor's banking book) is transferred to the SPV through the use of credit default swaps. In exchange for the credit protection, the sponsoring institution pays the SPV an annual fee. The default swaps on each of the obligors in the reference portfolio are structured to pay the average default losses on all senior unsecured obligations of defaulted borrowers. (See Figure 2 below for an example of this structure.)

In order to support its guarantee, the SPV sells CLNs to investors and uses the cash proceeds to purchase central government securities. The SPV then pledges the government securities to the sponsoring banking organisation to cover any default losses.[13] The CLNs are often issued in multiple tranches of differing seniority and in an aggregate amount that is significantly less than the notional amount of the reference portfolio. The amount of notes issued typically is set at a level sufficient to cover some multiple of expected losses, but well below the notional amount of the reference portfolio being hedged.

Figure 2



The first-loss position may be a small cash reserve, *which may be equal to or greater than expected losses in the reference portfolio.* This cash reserve accumulates over a period of

[13] The names of corporate obligors included in the reference portfolio may be disclosed to investors in the CLNs.

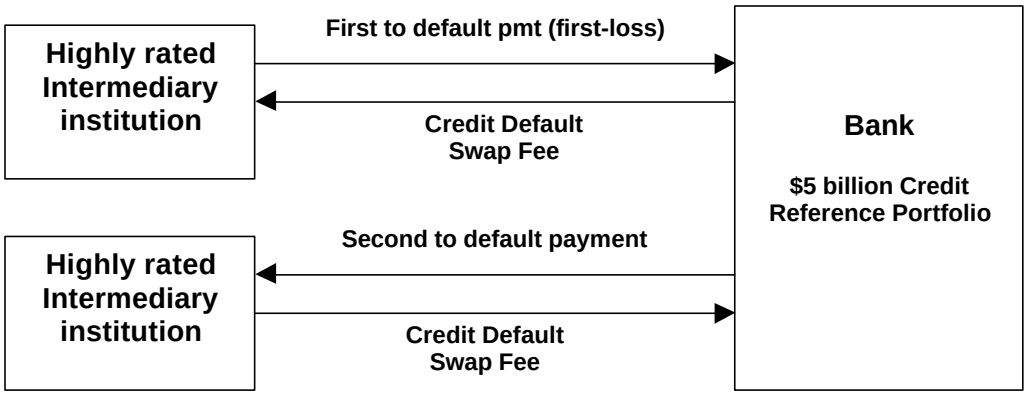
years and is funded from the excess of the SPV's income (i.e. the yield on the central government securities plus the credit default swap fee) over the interest paid to investors on the notes. The investors in the SPV assume a second-loss position through their investment in the SPV's senior and junior notes, which tend to be rated AAA and BB, respectively. Finally, the sponsoring banking organisation retains a high quality senior risk position that would absorb any credit losses in the reference portfolio that exceed the first- and second-loss positions.

Typically, no default payments are made until the overall transaction's maturity, regardless of when a reference obligor defaults. While operationally important to the sponsoring banking organisation, this feature has the effect of ignoring the time value of money. Thus, supervisors expect that when the reference obligor defaults under the terms of the credit derivative and the reference asset falls significantly in value, the sponsoring banking organisation should, make appropriate adjustments in its regulatory reports to reflect the estimated loss relating to the time value of money. These adjustments should be in accordance with generally accepted accounting principles

3. Bilateral transactions

Some recent transactions transferred the credit risk via credit default swaps between the bank and different highly rated counterparties. These transactions provide credit protection for the entire notional amount of the reference portfolio where the credit protection selling entities acquire tranches of credit exposure that have different levels of seniority. For example, one institution may purchase a first-loss position while a second institution purchases a second loss position. These tranches of purchased credit risk are not subject to market discipline since they are not rated by a rating agency and usually not traded. Because the tranches of this bilateral transaction are not rated, it may be difficult to ascertain their credit quality.

Figure 3

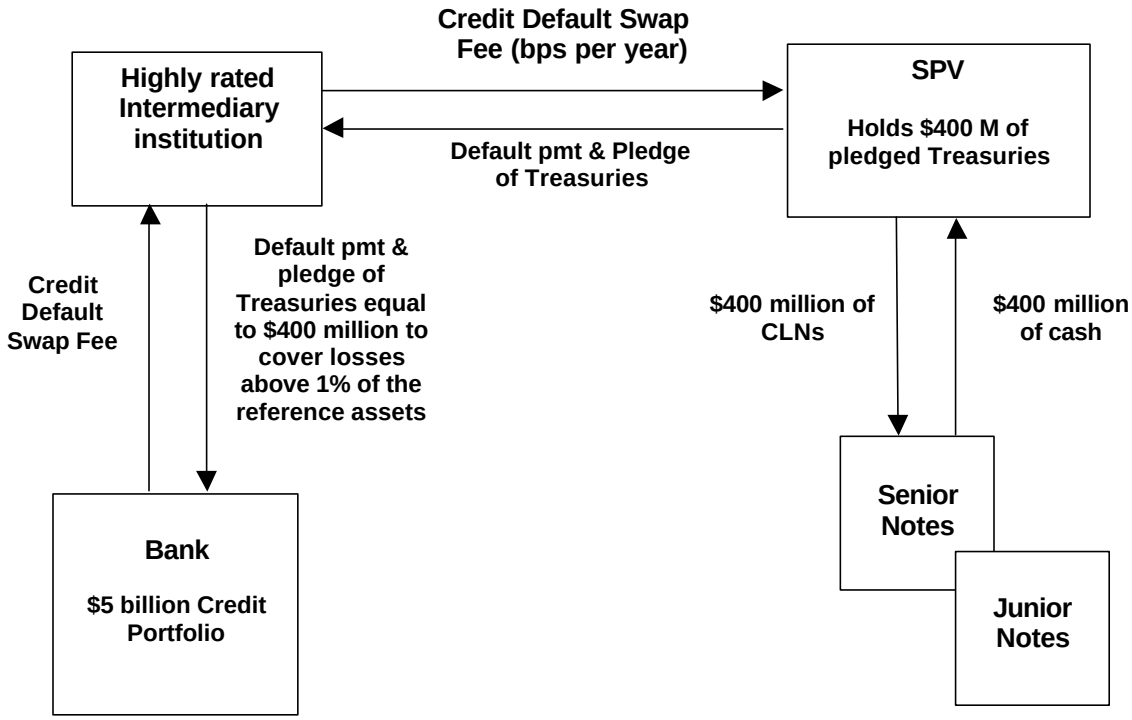


One variation of this bilateral structure involves the sponsoring bank retaining a first-loss position that may be equal to or greater than the expected loss on the underlying reference portfolio.

4. Utilisation of an highly rated intermediary institution

In certain synthetic transactions, the sponsoring banking organisation may retain the credit risk associated with a first-loss position and, through the use of credit default swaps, pass the second and senior loss positions to a third-party entity, most often an OECD bank. The third-party entity, acting as an intermediary, enters into offsetting credit default swaps with an SPV, thus transferring its credit risk associated with the second loss position to the SPV.[14] As described in the previous transaction type, the SPV then issues CLNs to the capital markets for a portion of the reference portfolio and purchases Treasury collateral to cover some multiple of expected losses on the underlying exposures.

Figure 4



[14] Because the credit risk of the senior position is not transferred to the capital markets, but instead, remains with the intermediary bank, the sponsoring banking organisation should ensure that its counterparty is of high credit quality, e.g. at least investment grade.