

February 15, 2011

Mr. Patrick M. Parkinson
Director, Division of Banking Supervision and Regulation
Board of Governors of the Federal Reserve System
20th and C Streets, NW
Washington, D.C. 20551

Re: Treatment of Exposures to Investment Funds as Securitization Exposures under the Basel II Advanced Capital Adequacy Framework

Dear Mr. Parkinson:

The purpose of this letter is to set forth the concerns of members of the American Bankers Association (ABA)¹ with respect to the broad classification by supervisors from the Federal Reserve of certain exposures as securitization exposures. We believe a meeting between the regulators and industry representatives is critical to resolve this significant issue.

In brief, bankers that are implementing the Basel II Advanced Capital Adequacy Framework (Basel II Advanced Framework), as adopted in this country by the Federal Reserve, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision (the Agencies) in the U.S. Basel II rule,² are concerned about the potential characterization by Federal Reserve supervisors of exposures to investment funds (including mutual, hedge, pension, and wealth management funds and funds of funds) as securitization exposures. We understand that banking organizations have been asked to consider all credit and derivative exposures to non-operating entities as possible securitization exposures. ABA strongly disagrees with this approach. An expansive definition of “securitization” would deprive the term of real meaning but lead to significant costs. As further elaborated below, we feel that –

- An exposure to an investment fund should not be presumed to be a securitization exposure. Investment funds differ significantly in form and substance from securitizations and therefore warrant more appropriate supervisory treatment.
- Requiring all exposures to investment funds to be treated as securitizations, subject to applications for exclusion, would senselessly require banks to apply for numerous exceptions, result in punitive capital charges, and be detrimental to both the banking and investment fund industries.

¹ The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's \$13.4 trillion banking industry and its two million employees.

² The Agencies, “Risk-Based Capital Standards: Advanced Capital Adequacy Framework – Basel II,” 72 Federal Register 69288, December 7, 2007, <http://edocket.access.gpo.gov/2007/pdf/07-5729.pdf>.

An exposure to an investment fund should not be presumed to be a securitization.

We draw your attention to banker concerns regarding the potential classification of wholesale exposures as securitization exposures. In particular, we understand that Federal Reserve supervisors have asserted that the following types of exposures may be classified as securitization exposures, notwithstanding the fact that they do not fit within the securitization framework and traditionally have been viewed (by the regulators and bankers alike) as wholesale (or equity) exposures:

- **any** exposure to an investment fund, notwithstanding the lack of significant leverage or risk,³ and
- credit exposures to mutual, hedge, and pension funds, funds of funds, and private trusts and wealth management funds, even though the exposures do not involve tranching of the underlying exposures.

Securitization involves tranching; investment funds do not.

Banking organizations subject to the Basel II Advanced Framework fundamentally disagree that an exposure to an investment fund should count as a securitization – for the simple reason that an investment fund does not involve tranching envisioned in the Basel II Advanced Framework.

In a typical securitization, a legal entity called a special purpose vehicle (SPV) is created to purchase a pool of underlying assets from independent originator(s) directly or through the market. Synthetic securitization is similar except that the assets stay with the originator(s) while the credit risk of those assets is transferred to the SPV in the form of credit default swaps or guarantees. In either case, the SPV funds what it purchases by issuing a hierarchy of debt securities such that some are specified in contract to be junior tranches, *i.e.*, they would absorb losses on the underlying securitization assets without interrupting the contractual payments to more senior tranches.

In contrast to a typical securitization, investment funds do not issue tranching securities.⁴ Rather, they issue equity interests (shares or membership or partnership interests) similar to equity interests issued by operating companies and funds. All investment fund equity holders are on the same level, albeit junior to senior debt or derivative obligations incurred by the fund with its trading counterparties and lenders. In a non-securitization structure, default by an obligor on any of its material liabilities constitutes a default on all of its liabilities. The difference between equity holders and debt holders in an operating or fund company structure is one of priority of claims in the insolvency or winding up of the obligor. This differs from the tranching of risk in a securitization, where a junior creditor can suffer losses while senior creditors are not impaired.

The U.S. Basel II rule recognizes that securitization must involve tranching. It refers to a securitization exposure as an on-balance sheet or off-balance sheet credit exposure that arises from a traditional or synthetic securitization for which one of the key characteristics is that “the credit risk

³ One ABA member was advised by Federal Reserve supervisors that repo-style transactions, margin lending, and OTC derivatives with investment fund counterparties should be considered as securitization exposures.

⁴ Hedge funds rarely issue debt securities, but some do. However, the debt securities that are issued are not tranching with respect to each other or with respect to counterparty credit risk.

associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority.”⁵ This position is consistent with the Basel Accord, which states⁶ –

A traditional securitisation is a structure where the cash flow from an underlying pool of exposures is used to service at least two different stratified risk positions or tranches reflecting different degrees of credit risk... The stratified/tranched structures that characterise securitisations differ from ordinary senior/subordinated debt instruments in that junior securitisation tranches can absorb losses without interrupting contractual payments to more senior tranches, whereas subordination in a senior/subordinated debt structure is a matter of priority of rights to the proceeds of liquidation.

Thus, a key consideration is whether the primary function of the vehicle is tranching; if not then it should not be considered to be a securitization.

We understand the Federal Reserve’s preliminary position to be that the use of leverage in an investment fund constitutes tranching of obligations. However, prioritization of debt over equity in an investment fund in case of default differs substantively from tranching of securitization debt securities. As noted above, should the investment fund default on its debt then the equity positions would also be at risk, whereas in a securitization one tranche can default without affecting others. Should supervisors view the existence of leverage in a counterparty as potential indication of securitization, virtually any business loan could be considered as a securitization exposure since the firm, small or large, would then involve both debt and equity positions. Indeed, high levels of debt are common in some industries, such as airlines and utilities, but it would make no sense to treat a loan to such a firm under the securitization framework.

In summary, an essential feature of securitization is the tranching of two or more liabilities into a hierarchy such that the junior tranched securities will initially absorb losses on the underlying assets without disrupting the contractual payments to the more senior tranched securities. In contrast, in a non-securitization structure a default on any material liability, regardless of its seniority, is considered a default by the obligor on all its liabilities.

Other differences between securitization and investment funds

Aside from tranching, several other factors clearly differentiate between bank exposures to investment funds versus securitizations.

- The underlying asset pool is restricted for a securitization but not for an investment fund.

The types of assets in which an investment fund manager may invest are generally not as constrained as is the case in a securitization. Rather, the fund adviser may pick a wide range of securities, currencies and derivatives in executing the fund’s investment strategies.⁷

⁵ 72 *Federal Register* 69288, December 7, 2007, at pages 69404-69405.

⁶ Basel Committee on Banking Supervision, “Basel II: International Convergence of Capital Measurement and Capital Standards,” June 2006, paragraph 539 on page 120 from “Part 2: The First Pillar – Minimum Capital Requirements,” www.bis.org/publ/bcbs128b.pdf.

⁷ A U.S. Securities and Exchange Commission staff report notes that hedge funds generally provide investors with a private placement memorandum that “generally provides the adviser with the maximum flexibility in

- The underlying asset pool is managed for an investment fund, but generally not for a securitization.

Investment managers manage the composition and risks of the underlying assets for an investment fund, just as the managers of other operating companies do. The funds usually invest in liquid positions and strategies and are actively managed with investment decisions based on the fund strategy and the historical performance of the management company in managing its funds. The investors pay the management of an investment fund a performance fee as compensation for the manager's skill at actively managing the underlying assets of the investment fund to generate a high return to investors relative to risk.

In contrast, the underlying asset pool in a securitization is generally fixed at the time the structure is created. The manager of a securitization pool is generally not rewarded for taking and managing risk.

- The risk-drivers of an investment fund differ from those of a securitization.

The primary risk for an investment fund is that the market values of underlying assets could fall. This risk depends in large part on the strategy employed by the manager, the degree of leverage of the fund, and the potential illiquidity of its assets. For securitization, the primary risk of a tranche is the realized default experience in the underlying pool of assets. This risk depends on the losses of those invariant assets, the existence of any supporting credit enhancement, and the priority of the tranche.

In sum, an investment fund that is in the business of investing in various asset classes and has the authority to move investments among managers and asset classes, and to increase or decrease its investor base, is an active operating business, even though it is not engaged in manufacturing goods. Such an entity is easily distinguishable from a single-purpose securitization SPV, which invests in a fixed quantity of assets and places debt and equity in multiple tranches with investors on terms related to the orderly liquidation of the assets.

An example

One example of an exposure that does not meet the definition of a traditional securitization exposure, but apparently has been so characterized by Federal Reserve supervisors at one or more banking organizations, is the provision of a credit facility to an investment or hedge fund. These credit facilities generally are short-term in duration and ancillary to the banking organization's funds administration and global custody business. A typical exposure would be a revolving line of credit to the fund to provide short-term liquidity or working capital through short-term advances, and to fund short-term foreign exchange transactions for hedging purposes. Credit is provided on conservative terms with conditions that prevent the use of the credit for speculative purposes or excessive gearing. The credit facility typically is fully secured and renewable at the discretion of the banking organization.

selecting, shifting and modifying its strategies." (U.S. Securities and Exchange Commission, "Implications of the Growth of Hedge Funds," September 2003, page ix, www.sec.gov/news/studies/hedgefunds0903.pdf.)

This example represents wholesale extensions of credit that are managed as wholesale exposures in a manner very different from securitization exposures. Their treatment under the regulatory capital rules should comport with their economic substance as short-term, low-risk, low-leverage exposures. The characterization of these and similar exposures as securitizations would result in excessive and punitive capital charges and, in many cases, the deduction of the exposure from regulatory capital. These excessive and punitive charges are not warranted based upon the economic substance of the underlying transaction and the relatively low level of risk to the bank.

Requiring all credit exposures to investment funds to be treated as securitizations, subject to applications for exclusion, is inappropriate and unworkable.

Broad classification of credit facilities and derivatives exposures to investment funds as potential securitization exposures would be a radical departure from current practice. Such credits have traditionally been risk managed and treated by the Agencies for regulatory capital purposes as wholesale exposures, or in some cases as equity exposures. These exposures do not have the risk transfer and tranching features of securitization exposures, and resolution of issues regarding the classification of specific exposures or classes of exposures could be a lengthy and inefficient process.

If a banking firm is required to treat credit facilities to investment funds under the securitization framework, then in many cases it will have to deduct the exposures from capital (since the Ratings-Based, Internal Assessment, and Supervisory Formula Approaches under the securitization framework are all ill-suited to investment funds). This could lead some banking firms to withdraw from the business of providing credit facilities to these funds. This result would be detrimental both to the banking and funds industries. Given the key role that investment funds play in the economy, the consequence would be particularly damaging at this stage of the economic recovery.

We understand from some of our members that supervisory broadening of the scope of the securitization definition has not been raised with all U.S. Basel II Advanced Framework banking organizations, or has been emphasized to differing degrees. We urge the Federal Reserve to coordinate with the other U.S. banking agencies regarding the supervisory approach to credit exposures to investment funds.

We also urge the coordination with other Basel II jurisdictions. Treating investments in hedge funds and similar leveraged funds by the securitization rules conflicts with the treatment of such investments under the European Union's Capital Requirements Directive (CRD). Under the CRD, investments in hedge funds or other leveraged funds are treated under the equity investments rules. Such investments are not risk weighted by the securitization rules. Article 87 Par. 11 & 12 of the CRD indicates that if a bank is able to meet the conditions for a look-through approach as described in Annex VI Par. 77-81 then risk-weighted assets should be computed in accordance with the Internal Risk-Based (IRB) rules (in Articles 84-89) for the underlying exposures. Otherwise, the banking organization should apply the equity rules in Annex VII (IRB Approach) under either the simple risk weight and internal model approaches (Annex VII. Par. 17-26). Under the CRD, the largest simple risk weight, 370 percent, is applied to the category "all other equity exposures."

Differences in application of the securitization paradigm raise “level playing field” and competitive concerns. A requirement to use the securitization framework would thus be economically unjustified and would place U.S. banks at a competitive disadvantage.

We are told that Federal Reserve supervisors have asked institutions that disagree with the broad classification as securitization exposures to request exemptions. This approach is inappropriate as it assumes inherently that the exposures are securitizations, a premise that the banking firms do not concede. From a practical standpoint, asking for exemptions for a large number of exposures would be grossly inefficient for the institutions and for Agency staff. An uncertain exemptive process adds to market uncertainty and delays the completion of many transactions that are critical to the continued functioning of the wholesale markets and the ability of the investment fund industry to secure needed funding.

Conclusion and Request for a Meeting

We urge the Federal Reserve to reconsider its treatment of routine extensions of credit to investment funds and exposures that do not reflect a transfer of credit risk or a tranching of the underlying exposure as securitization exposures. Such exposures should be treated as wholesale exposures, consistent with the economic substance and risk management of these facilities. ABA member banks affected by the potential characterization of these exposures as securitizations are concerned that a failure to classify these exposures as wholesale exposures for regulatory capital purposes will cause banks to withdraw from this market, to the detriment of banks, their fund customers, and the economy.

To avoid a burdensome exemption process, we further urge the Federal Reserve, in coordination with the other U.S. Agencies and with non-U.S. bank supervisors, to adopt clear guidance as to the definition of a securitization for regulatory capital purposes.

We request a meeting with Federal Reserve staff at the earliest possible date so that affected banking organizations and ABA staff may discuss these issues in greater detail. I will contact your office shortly to arrange a mutually agreeable date and time for such a meeting.

Respectfully submitted,

Robert W. Strand

Senior Economist

cc: Sandra L. Thompson
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