

October 18, 2011

Ms. Anna Lee Hewko
Division of Banking Supervision and Regulation
Board of Governors of the Federal Reserve System
20th and C Streets, NW
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Mr. Amrit Sekhon
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Mr. Robert Bean
Chief, Policy Section, Capital Markets Branch
Division of Supervision and Consumer Protection
Federal Deposit Insurance Corporation
550 17th Street, NW
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Re: Supervisory Treatment of Exposures to Investment Funds as Securitization Exposures

Dear Madam and Sirs:

The American Bankers Association¹ (ABA) and its members remain deeply concerned with the apparent regulatory interpretation of the banking agencies that the U.S. Basel II rule² provides for a presumption that every exposure to any investment fund is a securitization exposure unless proven otherwise. As expressed in our letter of February 15, we believe that requiring all exposures to investment funds (broadly defined) to be treated as securitizations, pending applications for exclusion, senselessly requires banks to apply for numerous exceptions, results in punitive capital charges, and is detrimental to both the banking and investment fund industries.³

On March 11, representatives from a dozen major banking firms met with staff from the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (the Agencies) to discuss these concerns. At that meeting, the Agencies requested a survey of affected institutions to demonstrate the magnitude of this issue. The bankers agreed to provide data regarding the aggregate number and size of bank exposures to investment funds, excluding exposures in the form of asset- and mortgage-backed securities (ABSs and MBSs). This letter responds to that request. Twelve banking firms with \$7.6 trillion of aggregate assets (56 percent of the U.S. banking industry) participated in the survey, for which results are presented here.

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; Final Rule," 72 *Federal Register* 69288, Dec. 7, 2007, <http://edocket.access.gpo.gov/2007/pdf/07-5729.pdf>.

³ Robert Strand letter to Patrick Parkinson, Feb. 15, 2011, www.aba.com/aba/documents/Basel/SecPol110215.pdf.

Size of Bank Exposures by Industry Segment / Major Type of Exposures*							
Investment Funds and Other Non-Operating Companies that Hold Financial Assets		Capital Markets and Trading	Direct Loans and Lending	Contingent / LCs and Guarantees	Investment Securities	Other	Totals
Hedge Funds	#	13,300	1,813	294	146	–	15,553
	\$B	\$83.2	\$9.3	\$0.4	\$2.8	–	\$95.8
Funds of Hedge Funds	#	88	113	4	0	–	205
	\$B	\$0.3	\$0.7	–	\$0.0	–	\$1.1
Sovereign Wealth Funds	#	121	22	–	0	–	143
	\$B	\$1.4	\$0.5	–	\$0.0	–	\$1.9
Pension Funds	#	5,255	1,323	16	0	–	6,594
	\$B	\$38.6	\$2.1	\$0.2	\$0.0	–	\$40.9
Other Funds and Separately Managed Accounts**	#	36,538	14,025	208	66	–	50,837
	\$B	\$157.9	\$56.1	\$2.0	\$3.9	–	\$220.0
Private Equity Funds	#	402	3,357	323	0	12	4,094
	\$B	\$1.2	\$38.6	\$1.5	\$0.0	\$0.4	\$42.6
Business Development Companies	#	642	2,568	–	0	–	3,210
	\$B	\$16.8	\$4.1	–	\$0.0	–	\$20.9
Not for Profit and Endowments	#	894	1,908	729	26	1	3,558
	\$B	\$8.3	\$32.5	\$18.3	\$3.1	–	\$62.1
Other	#	1,513	3,520	179	–	9	5,220
	\$B	\$22.5	\$22.0	\$0.7	\$0.0	\$0.1	\$45.4
Total	#	58,753	28,647	1,752	238	22	89,412
	\$B	\$330.2	\$166.0	\$23.1	\$9.8	\$0.5	\$529.6

* All of the figures in this table are approximations for the aggregate exposures for Bank of America Corporation, Bank of New York Mellon Corporation, Citigroup Inc., Goldman Sachs Group, Inc., HSBC North America Holdings, JPMorgan Chase & Co., Morgan Stanley, Northern Trust Corporation, PNC Financial Services Group, Inc., State Street Corporation, UnionBanCal Corporation, U.S. Bancorp., and Wells Fargo & Company as of Dec. 2010. The values presented represent total exposures, not total assets.

** “Other Funds” includes regulated and unregulated funds other than those listed elsewhere.

The survey results are not intended to suggest that all of the referenced bank exposures to investment funds are or should be considered to be securitization exposures. Rather the results are delivered solely to respond to the request for such data and to illustrate the volume and scope of bank exposures to investment funds held by U.S. banking firms subject to Basel II.

In presenting this data, we reiterate that ***we see nothing in the U.S. Basel II rule that creates a presumption that every exposure to an investment fund is a securitization exposure.*** To the contrary, the fact that an exposure is to an investment fund merely indicates that it shares ***one***

characteristic of a “traditional securitization,” namely that the underlying financial assets “are not owned by an operating company.” However, the U. S. Basel II rule sets forth not just one, but seven essential criteria for a traditional securitization:⁴

Traditional securitization means a transaction in which *all of the following elements* are present:

- (1) All or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties other than through the use of credit derivatives or guarantees;
- (2) The credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority;
- (3) Performance of the securitization exposures depends upon the performance of the underlying exposures;
- (4) All or substantially all of the underlying exposures are financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, mortgage-backed securities, other debt securities, or equity securities);
- (5) The underlying exposures are not owned by an operating company;
- (6) The underlying exposures are not owned by a small business investment company described in section 302 of the Small Business Investment Act of 1958 (15 U.S.C. 682); and
- (7) The underlying exposures are not owned by a firm an investment in which qualifies as a community development investment under 12 U.S.C. 24(Eleventh).

All seven of these criteria, not just clause (5), must hold for an exposure to qualify as a securitization exposure.

Clause (5) was added to the U.S. Basel II rule as a limitation to the definition in the international Basel II rule and in earlier proposed versions of the U.S. rule in order to reduce, rather than expand, its scope. Therefore, there is no basis in the rule for presumptive securitization treatment for every transaction where the underlying exposures are not held by an operating company. To do so could mean that all exposures to financial firms are presumptively securitization exposures since they cannot rely on the operating company limitation included in the U.S. Basel II rule. This is not how non-U.S. banks or their regulators are applying the international Basel II definition, and nothing in the U.S. Basel II rule suggests that U.S. banks should either.

We note further that ***the U.S. Basel II rule does not appear to provide for blanket presumptive classification of a broad class of exposures as securitizations.*** The rule states:⁵

- (8) The [agency] may determine that a transaction in which the underlying exposures are owned by an investment fund that exercises substantially unfettered control over the size and composition of its assets, liabilities, and off-balance sheet exposures is not a traditional securitization based on the transaction’s leverage, risk profile, or economic substance.
- (9) The [agency] may deem a transaction that meets the definition of a traditional securitization, notwithstanding paragraph (5), (6), or (7) of this definition, to be a traditional securitization based on the transaction’s leverage, risk profile, or economic substance.

...

⁴ 72 Federal Register 69288, Dec. 7, 2007, at page 69405.

⁵ 72 Federal Register 69288, Dec. 7, 2007, at pages 69405 and 69328.

The agencies have added a new component to the definition of traditional securitization to specifically permit a primary Federal supervisor to scope certain transactions into the securitization framework if justified by the economics of the transaction... The agencies will consider a number of factors when assessing the economic substance of a transaction including, for example, the amount of equity in the structure, overall leverage (whether on- or off-balance sheet), whether redemption rights attach to the equity investor, and the ability of the junior tranches to absorb losses without interrupting contractual payments to more senior tranches.

The intent appears to be that supervisors may scope certain transactions into the securitization space on a case-by-case basis as they gain experience with institutions operating under Basel II. We feel that this treatment is the appropriate supervisory approach to identifying exposures that do not meet all seven of the definitional criteria for securitization treatment.

We look forward to discussing our results and approach with you once you have had an opportunity to review the survey results.

Respectfully submitted,

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