



Insight beyond the rating.

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Filed Electronically

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Re: *Consultation Paper on Enhancements to the Basel II Capital Framework*
(*“Proposed Enhancements”*)

Dear Sirs/Madames:

DBRS appreciates the opportunity to comment on the proposed enhancements to strengthen the Basel II capital framework.

DBRS is a Toronto-based global credit rating agency established in 1976 and still privately owned by its founders. With offices located in New York and Chicago, DBRS analyzes and rates a wide variety of issuers and instruments, including financial institutions, insurance companies, corporate issuers, issuers of government and municipal securities and various structured transactions. DBRS currently maintains ratings on more than 43,000 securities in approximately 35 countries around the globe and rates approximately 100 of the largest banks in the world. DBRS has adopted and complies with the Code of Conduct Fundamentals for Credit Rating Agencies (“CRAs”) developed by the International Organization of Securities Commissions (“IOSCO Code”). DBRS is also registered with the U.S. Securities and Exchange Commission (“SEC”) as a nationally recognized statistical rating organization (“NRSRO”) and has achieved global regulatory recognition, including recognition as an External Credit Assessment Institution (“ECAI”) in Canada, the U.S., Switzerland and the European Union.

DBRS understands that the proposed enhancements are intended to help ensure that the risks inherent in a bank’s portfolio related to trading activities, securitizations and exposures to off-balance sheet vehicles are better reflected in minimum capital requirements (“Pillar 1 proposals”), in the supervisory review process including risk management practices (“Pillar 2 proposals”) and market discipline including better public disclosures to assist in understanding a bank’s overall risk management position (“Pillar 3 proposals”). DBRS comments are primarily focused on the Pillar 1 proposals. These proposals recommend a higher capital charge for re-securitizations, a higher charge for liquidity lines extended to support ABCP and require comprehensive disclosure about externally rated securitizations. Many of these proposals directly or indirectly affect the usage of credit ratings.



Context for DBRS comments

As context for its comments, DBRS wishes to note that it has implemented a number of changes over the last eighteen months across its business, with particular focus on Structured Finance, to enhance the quality and transparency of its credit rating process and to help restore confidence in credit rating opinions. In making these changes, DBRS has extensively dialogued with investors, regulatory bodies, financial markets supervisors and a wide variety of trade organizations. On March 5, 2009, DBRS published a commentary summarizing these changes. In particular, DBRS would like to highlight the initiation of a Global Liquidity Standard, the implementation of a Structured Finance Information Review Policy (“Information Review Policy”) and its efforts to increase transparency and disclosure to investors which is critical to properly functioning capital markets.

In Canada, a general market disruption standard was utilized for almost twenty years. In January 2007, DBRS initiated change regarding the use of this standard for rating Canadian asset-backed commercial paper (“ABCP”) conduits and, in September 2007, DBRS formally announced its updated criteria and outlined the global liquidity standard (“GLS”). DBRS worked with market participants to complete a review of existing conduits for GLS compliance by December 31, 2007. Presently, one hundred per cent of Canadian ABCP rated by DBRS carries global liquidity. DBRS also maintains a GLS-compliant list.

In early 2008, DBRS took the initiative to restructure its reporting to provide more timely and transparent disclosure on securitized transactions. This included revisions to Canadian ABCP conduit and term asset-backed securities reporting standards, process and level of disclosure to an individual transaction level on a monthly basis, which is now the leading disclosure of its type among all ABCP markets in the world. Investors and other stakeholders are able to determine the nature of the underlying assets on a transaction-by-transaction and conduit-by-conduit basis and perform their own analytics based on the performance of assets. Where new transactions are added to ABCP conduits, DBRS will disclose this and provide a summary of the nature of these new asset types and their related risks. DBRS will decline to rate ABCP conduits where an appropriate transaction level of information is not forthcoming.

In addition, during 2008, DBRS implemented an Information Review Policy that outlines the measures it adopted to ensure the information it uses in assigning a rating is of sufficient quality to support a credible rating. These measures include the review of asset data, legal documents and client information. This policy can be found under Rating Policies on www.dbrs.com.

In addition to DBRS’ own efforts, various regulatory bodies such as IOSCO and the SEC have increased oversight over CRAs and introduced new requirements. DBRS complies with all such SEC and IOSCO regulatory requirements. The G20 recently announced reforms toward a globally harmonized approach to CRA regulation, Europe is in process of finalizing a regulatory regime and Canada will soon follow. In this vein, while DBRS agrees with certain of the proposed enhancements, DBRS wishes to note that considerations to directly or indirectly reduce



the usage of credit ratings and/or change the capital risk weightings related to such usage is at odds with global actions and proposals for increasing CRA oversight.

General Comment - Equivalency of Rating References in Basel II documents

Where ratings are referenced in Basel II documents including the consultation paper on the proposed enhancements, DBRS requests that such regulatory rating references provide for ratings parity and equivalence among recognized CRAs. That is, any Basel II references to short-term and/or long-term ratings should include the specific rating categories of each of the eligible ECAs as per the credit assessment mapping tables established by various international bodies and regulators¹. This is critical as the rating categories and granularity are different between the eligible ECAs. Regulatory documents such as Basel II should not automatically default to or outline one recognized CRA ratings over another.

Pillar 1 Proposals

There are seven areas that comprise the Pillar 1 proposals. DBRS' comments are as follows:

1. Resecuritisation Risk Weights – Banks using the internal ratings-based (“IRB”) approach to securitisation will be required to apply higher risk weights to resecuritisation exposures starting at 20% for senior and 30% for non-senior exposures at the AAA long term and A1 short term ratings levels, respectively.
2. Standardised Risk Weights – Analysis to arrive at revised risk weights for resecuritisations in IRB demonstrated that the risk weights in the Standardised approach (“SA”) should also be altered for similar exposures.

The consultation paper proposes that resecuritisations warrant a higher capital charge in both the SA and IRB approach because they are more highly correlated with systematic risk than are traditional securitisations. Resecuritisations include: collateralised debt obligations (“CDOs”) comprised of asset-backed securities (“ABS”), also referred to as CDOs of ABS, CDOs of residential mortgage backed securities (“RMBS”), a liquidity facility to an asset-backed commercial paper (“ABCP”) programme and a transaction within such a programme that held ABS. Where the underlying exposure consisted of hundreds of mortgage loans and a single ABS, the securitisation exposure in question would be considered a resecuritisation.

DBRS suggests that higher capital weightings for resecuritisations in the SA and IRB approach should be based on the type and complexity of the resecuritisation exposure with consideration given to tranche thickness and structure as opposed to only the credit rating level of the resecuritisation. That is, resecuritisations of less complex and plain vanilla structures/assets or

¹ Such bodies and regulators would include among others, the Committee of European Banking Supervisors (“CEBS”), individual banking regulators in the European Union and Switzerland and the Office of the Superintendent of Financial Institutions Canada.



assets with greater tranche thickness and/or seniority warrant a modest increase in the capital charge versus a different and higher capital charge for more complex, very junior or new types of structures. DBRS is also interested in understanding the inputs to derive the proposed resecuritisation weightings between the senior and non-senior levels particularly at the A- rating category and below.

3. Use of Ratings Subject to self-guarantee – Banks would not be permitted to use ratings for exposures subject to self-guarantees adding language to the Basel II framework so that a bank cannot recognise ratings – either in the SA or in the IRB approach – that are based on guarantees or similar support provided by the bank itself.

The consultation paper states that during the recent market turmoil, several banks that provided liquidity facilities (“LFs”) to ABCP programmes chose to purchase commercial paper issued by the ABCP conduit instead of having the conduit draw on its LF. The LF provider then risk weighted the ABCP based on the paper’s external rating. As a result, the LF provider benefited from the external rating on the commercial paper when assigning a risk weight to that paper, even though the rating was due in large part to the bank’s own support of the conduit in the form of the LF.

The following three paragraphs are proposed to be added to the Basel II securitization framework:

1. A bank is not permitted to use any external credit assessment for risk weighting purposes where the assessment is at least partly based on unfunded support provided by the bank.
2. The treatment described above is also applicable to exposures held in the trading book.
3. Banks are permitted to recognise overlap in their exposures.

DBRS believes that the proposal to not permit the use of any external credit assessment may unduly penalize banks that hold ABCP simply because the bank is the sponsor of the ABCP. DBRS also suggests that external liquidity ratings should be permitted for risk weighting purposes where liquidity is drawn.

4. Operational Requirements for Credit Analysis – Banks would be required to meet specific operational criteria in order to use the risk weights specified in the Basel securitization framework. These criteria are intended to ensure that banks perform their own due diligence and do not simply rely on rating agency credit ratings. Failure to meet these criteria for a given securitisation exposure would result in its deduction (i.e. higher capital requirements).

The present risk based approach does not include specific operational requirements for banks to assess or conduct a credit analysis of an externally-rated securitisation exposure, both within and across structures. It is proposed that the paragraphs below be added to the Basel II framework to apply to both the SA and IRB approach and equally to the banking book and trading book. If a



bank did not perform the level of due diligence specified, it would have to deduct the securitisation exposure.

2.1 Information on the underlying collateral supporting securitisation exposures:

- As a general rule, a bank must, on an ongoing basis, have a comprehensive understanding of the risk characteristics of its individual securitisation exposures, whether on balance sheet or off balance sheet, as well as the risk characteristics of the pools underlying its securitisation exposures.
- Banks must be able to access performance information on the underlying pools on an ongoing basis in a timely manner. Such information may include, as appropriate: exposure type; percentage of loans 30, 60 and 90 days past due; default rates; prepayment rates; loans in foreclosure; property type; occupancy; average credit score or other measures of creditworthiness; average loan-to-value ratio; and industry and geographic diversification. For resecuritisations, banks should have information not only on the underlying securitisation tranches, such as the issuer name and credit quality, but also on the characteristics and performance of the pools underlying the securitisation tranches.
- A bank must have a thorough understanding of all structural features of a securitisation transaction that would materially impact the performance of the bank's exposures to the transaction, such as the contractual waterfall and waterfall-related triggers, credit enhancements, liquidity enhancements, market value triggers, and deal-specific definitions of default.

DBRS agrees that banks need sufficient information on the underlying collateral supporting securitisation exposures in order to conduct a credit analysis. Similarly, CRAs require a minimum level of information on the underlying collateral to provide a credit rating. DBRS would be pleased to assist in developing a minimum set of information requirements that could be used by banks and other market participants. Broad regulatory support/sponsorship for such requirements would be a critical success factor.

With respect to which party should conduct the due diligence, DBRS suggests that banks should be permitted flexibility in outsourcing it to external parties so long as the banks enter into appropriate outsourcing arrangements and contracts and these external parties have appropriate expertise.

5. Liquidity Facilities in the Standardised Approach – The credit conversion factor (CCF) for all eligible LFs in the SA securitisation framework would be made uniform at 50%, regardless of the maturity of the LF. Currently, eligible LFs under one year receive a 20% CCF in the SA.



The consultation paper notes that prior to the onset of the financial crisis, banks built up significant exposures to off-balance sheet conduits, which were not adequately reflected in the capital regime. The paper notes that most commitments in the securitization framework are in the form of liquidity facilities to ABCP programmes. In response, it is proposed that capital requirements be increased for liquidity lines extended to support ABCP conduits by eliminating the distinction between short-term and long-term liquidity facilities. In addition, if an external rating of the facility itself is used for risk-weighting the facility, a 100% CCF must be applied.

DBRS does not agree with completely eliminating the distinction between short versus long term liquidity facilities. As an alternative, DBRS suggests that a factor related to the riskiness of the underlying assets could be applied to a liquidity facility to recognize the time to maturity instead of a straight deduction.

DBRS is also concerned with the proposed 100% CCF to be applied to external ABCP ratings. An external rating of an ABCP conduit as well as an external rating on the associated liquidity facility provides investors with additional insight into the risk profile of that conduit. In addition, an external rating provides the bank sponsor of the ABCP with an opinion of the relative strength of the conduit. For example, DBRS ABCP and ABS ratings are predicated on a review and disclosure of the underlying assets on a transaction-by-transaction and conduit-by-conduit basis to allow investors to perform their own analytics. DBRS believe these benefits underscore the need for differentiation for the risk weighting treatment of ABCP conduits with external ratings.

6. Liquidity Facilities in the IRB Approach – Revised language will clarify when LFs may be treated as senior securitisation exposures.

Usually a liquidity facility supporting an ABCP programme would not be the most senior position within the programme; the commercial paper, which benefits from the liquidity support, typically would be the most senior position. However, a liquidity facility may be viewed as covering all losses on the underlying receivables pool that exceed the amount of over-collateralisation/reserves provided by the seller and as being most senior only if it is sized to cover all of the outstanding commercial paper and other senior debt supported by the pool, so that no cash flows from the underlying pool could be transferred to other creditors until any liquidity draws were repaid in full.

Existing Basel II language would be modified to clarify the distinction between LFs that should be treated as senior and those that should not. The proposed revisions are meant as a clarification of existing treatment, not a change to existing treatment.

DBRS agrees with this proposal to distinguish LFs that should be treated as senior from those that are not.



7. General Market Disruption LFs in the SA & IRB Approach – Favourable capital treatment afforded general market disruption LFs under the SA and under the Supervisory Formula Approach (SFA) in the IRB Approach would be eliminated.

The Basel II securitisation framework identified liquidity lines that carried unique limitations on their ability to be drawn that differed from other liquidity lines. It was designed to apply a preferential conversion factor of 0% (rather than 20% for other short-term LFs) under the SA securitisation framework. A preferential conversion factor of 20% (rather than 100% for other LFs) was also permitted under the SFA in the IRB securitisation framework. The proposal would be to eliminate any favourable treatment accorded to market disruption liquidity facilities under Basel II.

DBRS agrees with removing this preferential capital treatment noting that general market disruption is also no longer used in the global capital markets. As noted in its contextual opening remarks, one hundred per cent of Canadian ABCP rated by DBRS carries global liquidity.

Pillar 2 Proposals

DBRS is supportive of the Pillar 2 proposals to improve banks' assessments of their risk profiles and internal capital adequacy assessments. While DBRS suggests that credit ratings continue to serve as very useful reference points, they should not be considered a substitute for a banks' own risk evaluation. DBRS agrees that banks must conduct their own analyses of the underlying risks when investing in structured products and should not solely rely on credit ratings assigned to securitization exposures. What is more critical is that banks' compare their own analysis and assumptions to that published by CRAs as a means of testing their work.

A CRA's primary role and expertise is credit risk assessment. A credit rating is an opinion of credit risk, or more specifically, the probability of default and/or expected losses regarding the relative future credit risk of an entity, a credit commitment or a debt or debt-like security. As such, a CRA does not take into account other risk factors that banks may need to consider in their internal capital adequacy assessments.

Conclusion

CRAs perform an important capital markets and regulatory function. Credit ratings continue to provide an independent point of reference for investors, issuers, regulators and others especially given the global regulatory and CRA initiatives to bolster CRA independence, integrity and transparency. On this basis, DBRS suggests that certain proposed enhancements to reduce the usage of credit ratings and/or change the risk weightings for such usage should be reconsidered. A clear and transparent framework around the usage of external credit ratings will allow for more effective communication of credit risk to market participants.



DBRS appreciates the opportunity to comment on this important set of proposed enhancements. Please do not hesitate to contact me should you have any questions and/or wish to discuss DBRS views.

Very truly yours,

A handwritten signature in black ink, appearing to read "Mary Keogh". The signature is fluid and cursive, with a large initial "M" and a long, sweeping tail.

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