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From: rhugi@mayerbrown.com [mailto:rhugi@mayerbrown.com]
Sent: Wednesday, June 07, 2000 7:24 PM
To: comments@fdic.gov; public.info@ots.treas.gov;
regs.comments@occ.treas.gov
Subject: Recourse Proposal - Master Trust Comment

We are pleased to submit the attached letter on behalf of the organizations identified on Schedule I to the letter. This letter comments on the "managed assets" proposal in the March 8, 2000 Joint Notice of Proposed Rulemaking relating to Risk-Based Capital Standards; Recourse and Direct Credit Substitutes. We are also sending a hard copy of the attached for delivery to you tomorrow.

Should you have any questions about the attached, please feel free to contact any of the following individuals:

Vernon Wright, Vice Chairman and Chief Corporate Finance Officer,
MBNA
America

Bank, N.A. (302/453-2074)
Robert Hugi, Partner, Mayer, Brown & Platt (312/701-7121)

June 7, 2000

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal
Reserve System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551

Robert E. Feldman
Executive Secretary
Attn: Comments/OES
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Communications Division, Third floor
Office of the Comptroller of the
Currency
250 E Street, SW
Washington, DC 20219

Manager, Dissemination Branch,
Records Management & Information
Policy
Attn: Docket No. 2000-15
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552

Re: *Risk-Based Capital Standards; Recourse and Direct Credit Substitutes—
Master Trust Comment*

Ladies and Gentlemen:

The organizations listed on Schedule I (the “*Commenting Group*” or “*we*”) wish to thank the member agencies (the “*Agencies*”) of the Federal Financial Institutions Examination Council for this opportunity to comment on the March 8, 2000 Joint Notice of Proposed Rulemaking relating to Risk-Based Capital Standards; Recourse and Direct Credit Substitutes (the “*Proposal*”).¹ In general, we support the Agencies’ efforts to more closely align bank capital requirements with the actual risks that capital is meant to cover.

However, we are strongly opposed to the Agencies’ proposal to require banks to hold capital (with a 20% risk weight or credit conversion factor) against assets securitized in transactions that include an early amortization feature.² In this letter we comment only on that proposal, which we refer to as the “*managed assets approach*.”

The members of the Commenting Group (or some members of trade associations included in the Commenting Group) have substantial credit card programs, which we finance in part through securitizations that include early amortization features, or are otherwise involved in credit card securitizations. As a result, we are among the institutions that would be most significantly affected by the adoption of a managed assets approach. We believe we are also among the best-qualified parties to speak to the purposes and effects of early amortization provisions.

We object to the managed assets approach on several grounds, including that:

¹ 65 Fed. Reg. 12320.

² 65 Fed. Reg. 12330.

- Typical early amortization features do not constitute credit recourse.
- The additional minimum capital required under the managed assets approach would be duplicative of capital currently required for sales with recourse.
- The managed assets approach seems to be largely aimed at liquidity concerns, not the credit risks that the risk-based capital system is designed to address.
- The liquidity management issues created by master trust funding are not so different from other funding sources as to justify this additional capital charge and are already addressed in the regulatory CAMELS process.
- Any regulatory benefits that might be gained by imposing this additional and excessive capital requirement would be outweighed by increases in the cost and/or decreases in the availability of credit that we believe would result if the new requirement were imposed.

We believe that existing disclosure practices, combined with case by case supervisory discussions of liquidity and contingency planning, represent an adequate and appropriate regulatory approach to the issues created by early amortization features.

We will discuss our objections to the managed assets approach in further detail in *Part II* below. Before we do so, it may be helpful to give a brief description of a typical credit card master trust with a bank seller.

I. Description of a Typical Credit Card Master Trust.

In a typical credit card securitization, a bank with a credit card program designates a set of credit card accounts and transfers balances in those accounts to a master trust. The bank sells only the balances arising in the accounts and does not sell the account relationships. Additional accounts may from time to time be added to the designated set of accounts from which balances are transferred to the trust. Subject to specified conditions, accounts may also be removed from that set.

Unless an account has been removed in accordance with the specified conditions, all balances arising from new purchases or other advances made under the account continue to be transferred to the trust so long as the trust remains in existence. This avoids the administrative difficulty of dividing account collections between balances that are in the trust and those that are not. It is also consistent with the ongoing issuances of securities by a master trust.

From time to time, the master trust issues series of investor certificates, which represent beneficial interests in the trust and typically include at least two classes of interests: Class A Certificates (generally rated AAA or its equivalent); and Class B Certificates (generally rated in the A category). Often a series includes a third class of

interest, referred to as a “Collateral Interest”, which is effectively an uncertificated Class C “Certificate.” Collateral interests are generally rated in the BBB category or structured so that the parties believe that they could be rated in that category.

Recently, some banks have begun to securitize through trusts that issue notes instead of certificates. This difference in form does not materially change the substance of these transactions as summarized below.

A. Invested Amounts and Allocation Percentages.

The investors’ principal investment in the trust is limited to the initial principal amount of their certificates, minus

- (a) principal payments received by the investors (or funds set aside for such payments), which generally do not occur during a “revolving period” that lasts for a number of years after the particular series of certificates is issued;
- (b) the investors’ share of charged off receivables that are not covered by investor finance charge collections or credit enhancements; and
- (c) in the case of junior classes, principal collections allocated to that class that are reallocated to cover claims of the more senior classes.

The net amount at any time determined above for a particular class is often called that class’s “*invested amount*,” and the sum of the class invested amounts in a series is called the series’ invested amount.

The mechanisms referred to in clauses (b) and (c) above are described further in *Part I.B.* below. The point we wish to make now is that an investor’s investment gives the investor a claim of a generally fixed principal amount on the pool of receivables held by the trust. That claim is subject to reduction once an investor begins to receive its investment back and through credit loss sharing and allocation mechanics.

Unlike the investors’ claims on trust assets, which tend to remain constant from day to day, the aggregate receivables balances in a trust tend to vary each day, as cardholders make new purchases using their cards and cardholder payments are received. These fluctuations are generally reflected in the size of the seller’s interest in the trust. The amount of the seller’s interest on any day can be calculated as the aggregate principal receivables in the trust minus the series invested amounts of all then outstanding receivables. For instance, assuming a trust with one outstanding \$500 million series of investor certificates, the seller’s interest would vary as shown in Table 1 below, as the aggregate principal receivables in the trust varied.

Table 1. Illustration of Seller's Interest Calculations.

	Day X	Day Y	Day Z
Aggregate principal receivables	\$550,000,000	\$560,000,000	\$545,000,000
Series invested amount	\$500,000,000	\$500,000,000	\$500,000,000
Seller's interest	\$50,000,000	\$60,000,000	\$45,000,000

The seller's interest is not, however, meant to absorb the investors' share of credit losses on the securitized receivables. To keep it from doing so, a share of the credit losses is allocated to each series as described below. The seller receives a share of collections commensurate with its pro rata interest in the trust, and those collections are not available to protect investors from credit losses. The seller's percentage of collections equals 100% minus the applicable investor percentages for each outstanding series, as described below.

The investors in each series are entitled to a fraction of the collections on the securitized receivables and are allocated a fraction of the credit losses on the securitized receivables. For administrative convenience, the percentage used to allocate collections and credit losses is generally set at the end of each month for all activity occurring in the following month. The percentage used is generally called the "floating allocation percentage," which equals the percentage equivalent of the following fraction:³

$$\frac{\text{series invested amount}}{\text{aggregate principal receivables}}$$

For instance, given the information in Table 1 above, if days X, Y and Z were all the final days of calendar months, then the allocation percentage for the immediately following months (rounded for convenience of presentation here) would be 90.9% (500/550), 89.3% (500/560) and 91.7% (500/545).

³ Some trusts instead allocate all collections and credit losses among the various series and then split collections and credit losses between investors and the seller within each series. This is accomplished with some variation on the following formulae:

- allocations among the series are made with a "series allocation percentage" that is defined as:

$$\frac{\text{series invested amount}}{\text{sum of series invested amounts for all outstanding series}}$$

- allocations to investors are then made from the collections and credit losses so allocated to the series using a floating allocation percentage (or principal allocation percentage, as discussed further below in the text) that is defined as

$$\frac{\text{series invested amount}}{\text{series allocation percentage} * \text{aggregate principal receivables}}$$

On a net basis, these formulae generally put the investors and the seller into pretty much the same position as the formulae discussed in the text.

The one exception to this formula is that once the revolving period for a series ends, the allocation percentage used to allocate principal collections to the series is generally determined using the series invested amount at the end of the revolving period as the numerator⁴. This is necessary to keep the pay down period from becoming excessively long, as it would be if investors received a smaller and smaller share of principal collections as their remaining investment was reduced. It is not meant to shift risk from investors back to the seller. The effect on investors of a declining share of principal collections is discussed further below.

In the ordinary case, a bank does not expect the aggregate assets in a master trust to decline just because a particular series of investor certificates has finished its revolving period. The bank expects the aggregate principal receivables in the trust to remain level or grow. This is because all of the balances arising in existing and new accounts designated as part of the trust portfolio continue to be transferred to the trust.

In this expected case, if the numerator for determining the allocation of principal collections to a series were not fixed at the end of the series' revolving period, then the share of principal collections allocated to the series would grow smaller and smaller over time. This is because the numerator for determining the investor allocation percentage would decrease every month, while the denominator would remain steady or grow. This situation is illustrated in Table 2.

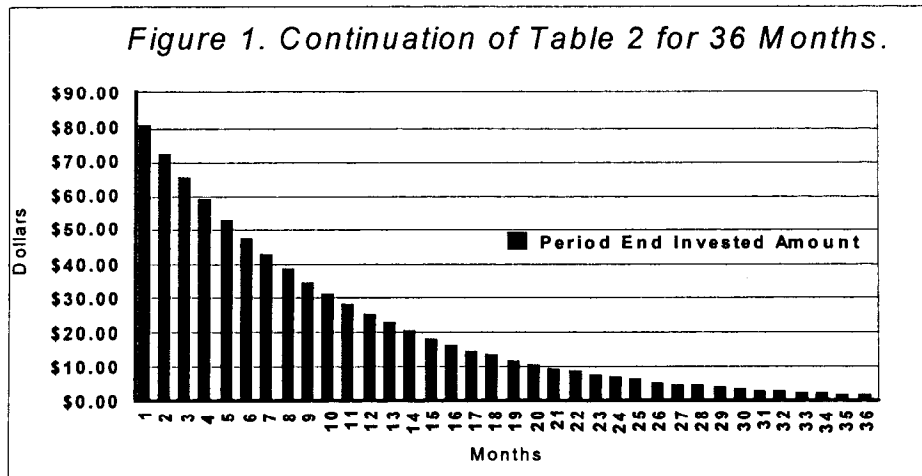
Table 2. Principal Allocations with Declining Numerator and Steady Denominator.

Month	Pool size	Beginning	Investor Percentage	Principal Collections	Investor Share	Period End
		Invested Amount				Invested Amount
1	\$100.00	\$90.00	90.00%	\$10.00	\$9.00	\$81.00
2	\$100.00	\$81.00	81.00%	\$10.00	\$8.10	\$72.90
3	\$100.00	\$72.90	72.90%	\$10.00	\$7.29	\$65.61
4	\$100.00	\$65.61	65.61%	\$10.00	\$6.56	\$59.05
5	\$100.00	\$59.05	59.05%	\$10.00	\$5.90	\$53.14
6	\$100.00	\$53.14	53.14%	\$10.00	\$5.31	\$47.83
7	\$100.00	\$47.83	47.83%	\$10.00	\$4.78	\$43.05
8	\$100.00	\$43.05	43.05%	\$10.00	\$4.30	\$38.74
9	\$100.00	\$38.74	38.74%	\$10.00	\$3.87	\$34.87
10	\$100.00	\$34.87	34.87%	\$10.00	\$3.49	\$31.38

In the illustration above, the aggregate principal collections over the period shown (10*\$10) equals the aggregate principal receivables at the beginning of the period (\$100), yet investors are not paid out at the end of the period. This is because their share of collections declines over time as their declining invested amount makes up a smaller and smaller percentage of the pool balance.

⁴ In some trusts, the numerator for allocating principal collections is not fixed unless an actual shortfall in available principal collections occurs (including shared collections from other series).

In fact, because the investors' share of collections keeps declining, it would take an extraordinarily long time to pay back the investors' investment. In many scenarios, using the declining series invested amount as an allocation numerator creates an asymptotic function, meaning that the slope of the decline in the invested amount keeps decreasing as it approaches zero in such a way that it would theoretically never reach zero. This is illustrated in Figure 1 below, which continues the illustration in Table 2 through 36 months.



This situation is avoided by fixing at least the numerator in a series' principal allocation formula at the end of the revolving period for the series. Some trusts also fix the denominator. In either case, we refer to the resulting percentage below as the "principal allocation percentage."

B. Allocations of Collections and Credit Losses.

Collections and credit losses on the accounts designated to a master trust are allocated between the selling bank and investors. The percentages used for these allocations are generally as follows:

- Finance charge collections and credit losses are at all times allocated to each series of investor certificates based on the floating allocation percentage for the series.
- Principal collections are allocated to a series based on the floating allocation percentage during the revolving period and based on the principal allocation percentage after the revolving period ends.

A bank that issues credit cards expects the finance charges and other revenues from its credit card business to cover the credit losses on its credit card portfolio. Similarly, investors in master trust certificates are expected in the ordinary course to

cover their pro rata share of the credit losses on the trust's receivables with their pro rata share of finance charge collections and, in some cases, other revenues (such as fees or interchange).⁵ This is accomplished through the cash application provisions of the master trust documents.

In some trusts (so called "capitalist trusts"), these applications are made solely (or initially) on a series-by-series basis. In others (so called "socialist trusts"), they are made on a shared basis among all outstanding series of investor certificates (or groups of outstanding series). In either case, on a monthly basis the investors' share of finance charge collections (determined using the floating allocation percentage) are applied to the following items:

- to pay an arms-length servicing fee to the selling bank, which continues to send out monthly statements, handle cardholder inquiries and otherwise service the trust's receivables;
- to pay interest to the investors at an agreed contractual rate; and
- to cover the investors' share of credit losses on the trust's receivables (determined using the floating allocation percentage).

Any excess remaining may be made available to cover similar items for other investor series or trapped in "spread accounts" or other cash accounts that provide credit enhancement for the investor certificates. Any excess remaining after these additional uses is ultimately paid to the selling bank, which gives rise to the interest only strip asset that many banks book under generally accepted accounting principles as a result of these transactions.

What does it mean that the investors' share of finance charge collections is used to "cover" the investors' share of credit losses? Essentially, it means that a portion of those collections (in an amount equal to the investors' share of the credit losses) is treated like principal collections. The finance charge collections take the place of the collections that should have been received on the charged off receivables, filling the asset gap created by the credit loss. If the revolving period for a series has ended, these converted collections are used to make principal payments to the investors or set aside to make such payments in the future, like actual principal collections allocated to the series. During the revolving period for a series, converted finance charge collections are generally paid to the selling bank as a reinvestment in new and outstanding principal receivables, again paralleling the treatment of investors' share of actual principal collections.

If the investors' share of finance charge collections are not sufficient to cover the investors' share of credit losses, then draws are made on any available credit enhancement, which typically take the form of cash collateral accounts and/or subordinated certificates. To the extent that any of these credit enhancements are

⁵ For convenience, all revenues allocable to investors are referred to below as "finance charges" or "finance charge collections."

provided by the selling bank, the bank is required to hold capital against the securitized receivables, subject to the low level recourse rule.

C. Early Amortization Provisions.

The fundamental measure of how well a credit card securitization (and the underlying portfolio) is performing is whether or not the investors' share of finance charge collections is sufficient to cover servicing fee, investor coupon and the investors' share of credit losses. This is demonstrated by the fact that the only early amortization event in most credit card securitizations that relates to portfolio performance is the so-called "base rate test." That test compares

- the investors' share of finance charge collections, net of the investors' share of credit losses (such net number being commonly called "portfolio yield") to
- the sum of the investors' servicing fee and investor coupon (such sum being commonly called the "base rate").

If the portfolio yield is less than the base rate on average over three consecutive months, then the revolving period will terminate early and an early amortization or similar period will begin.

The other events that can cause an early amortization of a series are generally limited to bad acts by the selling bank (such as a material misrepresentation or breach of covenants), a decline in the pool balance below required levels or events that threaten the legal integrity of the transaction, such as insolvency of the selling bank. These matters are generally either within the selling bank's control or so remote as not to present a material risk to the selling bank. As a result, in discussing the managed assets approach to credit card securitizations, we believe it is appropriate to focus almost exclusively on the base rate test.

II. Why the Managed Assets Approach is Inappropriate.

It appears that the managed assets approach is intended to address either a concern that early amortization features create some type of disguised recourse to the selling bank or that they create liquidity or other non-credit risks that justify an additional capital charge relating to these transactions. As discussed more fully below, we do not believe that these transactions involve credit or other risks that justify this extraordinary capital treatment.

A. Typical Early Amortization Features do not Constitute Credit Recourse.

Early amortization features are not designed to shift credit risk from investors to a bank that securitizes receivables. When rating agencies rate a series of master trust certificates, they set the required level of credit enhancement for each class of certificates based on the amount of credit losses to which the series may be exposed in a stress (*i.e.*,

high loss) scenario over the period of time that they believe it might take to recoup the investors' investment in a stress (*i.e.*, slow payment speed) scenario. The rating agencies do not rely on the securitizing bank to cover losses. They require adequate structural credit enhancements to cover the investors' share of losses.

In the ordinary course, the parties to a credit card securitization do not expect any draws to be made on the credit enhancement. It is generally expected that investors' share of finance charge collections will be adequate to cover servicing fees, investor coupon and the investors' share of credit losses. As a result, credit enhancement is not sized to provide any protection during the revolving period, which often lasts from two to four years and sometimes is substantially longer. Credit enhancement is sized to cover loss exposure over the period that it takes to repay investors, if portfolio performance deteriorates to the point where material draws are made on the credit enhancement. The purpose of an early amortization feature, from the rating agencies' point of view, is to detect a significant deterioration in portfolio performance and start the pay out process before a material portion of the credit enhancement is used up.

Given these structural facts, there is no need for the Agencies to impose an additional charge for credit risks relating to securitizations with early amortization features. The investors' share of the credit risks relating to existing receivables in these transactions is covered through the credit enhancement structure embedded in the securitization. If the selling bank provides any of those credit enhancements, then its share of the risks is already covered through what usually amounts to dollar for dollar capital on the amount of the exposure, under the low-level recourse rule.

The Proposal states: "The early amortization feature ensures that investors will be repaid before being subject to any risk of significant credit losses."⁶ We respectfully submit that this is not correct. The base rate test, which is the key event that might start an early amortization, is tripped at roughly the point when credit enhancement draws start to be made, meaning that the protection for at least the most junior level of investor certificates is being eroded. Although the credit enhancement is set at a size that is expected to last through the pay down period, it is always limited in amount. There is always a possibility that it will be exhausted, in which case investors would bear directly their share of the losses on the portfolio.

Importantly, the credit enhancement generally takes one or more of the following forms:

- subordinated classes that are held by parties other than the selling bank and its affiliates; or
- spread accounts, which are funded either from the investors' share of finance charge collections (before an absolute short fall arises) or from initial deposits by the selling bank (or both).

⁶ 65 Fed. Reg. 12330.

Subordinated classes held by unaffiliated third parties do not impose any risk of credit loss on the selling bank. To the extent that spread accounts are reflected as assets on the selling bank's balance sheet, banks are already required to hold dollar for dollar capital against them under the low-level recourse rule.

B. Liquidity Issues do not justify the Managed Assets Approach.

The Proposal also refers to liquidity problems that an early amortization can create for a seller.⁷ It is true that loss of funding from a master trust would require a securitizing bank to seek other funding sources or to pursue other business options. However, this type of liquidity planning and contingency management has not conventionally been dealt with through the risk-based capital framework, and we do not think the risk-based capital framework is the appropriate way to handle this issue.

In this connection, it is worth noting that credit card issuers generally have the contractual right to reduce or terminate credit lines. As a result, this line of business is one that provides banks with more than one way of responding to a loss of funding availability for its credit card program. Issuers can also consider portfolio sales as another exit scenario and potential liquidity source.

Any well-run bank has to plan for possible shifts in availability of its funding sources, and liquidity is reviewed as part of the regulatory examination and reflected in a bank's CAMELS rating. In banking organizations with substantial reliance upon master trust funding, the applicable bank supervisor may wish to review these contingency plans as a safety and soundness matter. In many or most cases, we believe that the banking organization will be able to demonstrate to its supervisor that it has adequate alternatives available to it and that no incremental capital charge relating to the managed securitized assets is necessary. As a result, we do not think it would be appropriate to automatically impose a capital charge on managed assets whenever a bank uses a securitization structure with an early amortization feature.

Another factor that a bank considers in liquidity planning is how high is the probability that an early amortization event will occur. Before executing a revolving securitization with an early amortization feature, a bank will look at a variety of stress tests to determine how much the performance of the portfolio would have to deteriorate in order for it to fail the base rate test and start an early amortization. A prudent bank generally will not complete the transaction unless it is highly confident that this will not occur. The historical record indicates that banks as a whole have done very well at this analysis, as the number of early amortizations that have occurred is very small, especially as a percentage of the numerous transactions that have been completed.

C. Implicit Recourse Should Not be Presumed in Master Trust Transactions.

The Proposal also suggests that the two perceived risks discussed above "can create an incentive for the seller to provide implicit recourse—credit enhancement

⁷ 65 Fed. Reg. 12330.

beyond any pre-existing contractual obligation—to prevent early amortization.”⁸ Although we are aware that some institutions may have chosen to provide additional enhancement in particular circumstances, we object to what would effectively be a regulatory presumption that implicit recourse would be provided. A bank confronted with deterioration in a securitized portfolio of credit card receivables has a number of options to consider, such as repricing or adjusting credit limits. It is by no means certain that providing additional recourse is the option that would always be selected. In addition, bank regulators currently have the authority to increase capital requirements or take other actions when a bank provides implicit recourse. We believe that these existing regulatory powers are adequate to deal with this issue on a case by case basis. An individualized approach where implicit recourse has been provided is more appropriate than a blanket presumption that it will be provided.

Along these lines, the Basel consultative paper⁹ that first proposed the managed assets approach seems to have recognized that the managed assets capital charge might be an extraordinary step to take when justified by particular circumstances. That paper said that the capital charge on managed assets would apply “when, in the opinion of the supervisor, uncontrolled early amortization or master trust agreements may pose special problems to the originating bank.” Although we object to the managed assets approach in its entirety, we believe that the case-by-case application contemplated by the Basel paper would be more appropriate than the blanket capital charge on managed assets contemplated by the Proposal.

D. Pricing and Credit Availability would be Negatively Affected by the Proposal.

We believe that current capital rules require banks to hold more than enough capital in connection with securitized credit card portfolios. An increase in required capital is likely to either increase the cost of credit to consumers or impair the profitability of issuing banks as banks either pass on the cost of additional capital to consumers or are unable to fully do so. It is also likely to reduce the availability of this form of credit. Some banks may not be willing to commit the full amount of capital necessary to maintain their current or projected portfolios, and competition of new entrants is likely to be reduced if the capital required for the business exceeds what is economically necessary.

E. Disclosure of Early Amortization Risks.

The Proposal acknowledges that “there may be concerns that the managed assets approach may not produce safety and soundness benefits commensurate with the additional regulatory burden that would result from a 20% risk weight on managed assets.”¹⁰ As a result, the Proposal requests comment on possible alternative measures that would address more effectively the risks arising from early amortization provisions

⁸ 65 Fed. Reg. 12330.

⁹ Basel Committee on Banking Supervision, *A New Capital Adequacy Framework* (June 1999), Annex 2, paragraph 36.

¹⁰ 65 Fed. Reg. 12331.

in revolving securitizations, including greater public disclosure of securitization performance.

We agree that disclosure is a more suitable approach to this issue, but we question whether any additional disclosure is needed. Most banks that securitize credit card receivables using master trusts are contractually required to provide information to investors on a monthly basis that includes, among other things, a calculation of the base rate test, or information sufficient to permit an investor to make that calculation. As stated above, the base rate test is the key measure that the market uses to assess the performance of these transactions, and it ties directly into the key early amortization event in these transactions. We believe that this existing disclosure, combined with case by case supervisory discussions of liquidity and contingency planning, represents an adequate and appropriate regulatory approach to the issues created by early amortization features.

III. Conclusion

If the Agencies continue to believe that a managed assets approach is appropriate, we request that this aspect of the Proposal be separated from the balance of the Proposal and held back for additional deliberation, either in the context of the Basel consultative process or domestically. The balance of the Proposal consists of ideas that the Agencies have discussed with market participants over a period of years. We believe that extended process has yielded significant benefits in terms of balancing regulatory and market considerations.

In contrast, the managed assets approach was first proposed at the international level only one year ago. The discussion of the managed assets approach in the Basel consultative paper was so brief that market participants did not have a good idea of the regulatory thinking behind the approach until the Agencies published the Proposal in March of this year. Also, only with the March publication of the Proposal did the managed assets approach move from a case-by-case remedy to a blanket capital charge. We strongly believe that the ramifications of the Proposal and other alternative measures should be discussed further before any additional capital requirement is imposed.

Respectfully submitted.

Commenting Group*

America's Community Bankers
Banc of America Securities LLC
Bank of America Corporation
Bear, Stearns & Co. Inc.
Capital One Financial Corporation
The Chase Manhattan Corporation
Citigroup Inc.
Deutsche Bank Securities Inc.
First USA Bank, N.A. (subsidiary of BANK ONE CORPORATION)
Fleet Credit Card Services
Greenwood Trust Company
MBNA Corporation
Morgan Stanley Dean Witter & Co.
People's Bank
Providian Financial Corporation
Wachovia Bank, N.A
World Financial Network National Bank

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