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From: Young, Walter [mailto:Walter_Young@afcc.com]
Sent: Wednesday, June 07, 2000 9:35 AM
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Cc: 'SCHOMBURG III, WILLIAM H'; 'Walter.Bauer@CIBC.com';
'lmatz@mciworld.com'; aisaac@owc.com'.treas.gov;
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Subject: Risk Based Capital Standards; Recourse and Direct Credit
Substitu tes; Proposed Rule: NALMA response

Dear Regulators:
June 7, 2000

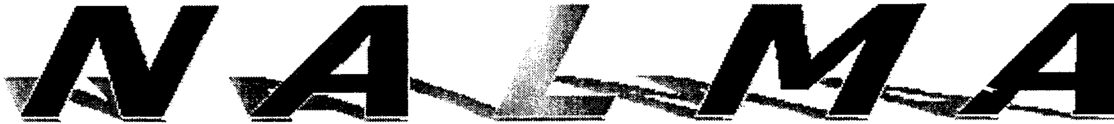
Attached is a response to the Risk Based Capital Standards; Recourse and
Direct Credit Substitutes; Proposed Rule. The response comes from
NALMA,
the National Asset & Liability Management Association. NALMA is
comprised
of 25 practitioners and consultants in the fields of asset / liability
management and economic capital allocation. Membership is largely
composed
of US and Canadian financial institutions. We are affected by the
proposal
in several ways: (1) as securitiziters of loan assets, (2) as users or
sponsors of asset-backed commercial paper (ABCP) conduits, and (3) as
investors in asset-backed securities. Our response represents the
opinion of
the collective group, and does not represent the opinion of any
individual
financial institution. Again, NALMA appreciates the opportunity to
provide
the Agencies with our views on such an important topic. We would be
happy
to answer any questions or provide further thoughts on this issue.

We also invite any of the regulators to come speak at one of our
semi-annual
meetings on topics of joint interest. In Sept. 2000 we meet in Toronto,
in
April 2001, we will meet in Orlando.

Thank you for your consideration in these matters.

H. Walter Young
NALMA President

972-652-4233
Vice President



NORTH AMERICAN ASSET AND LIABILITY MANAGEMENT ASSOCIATION

June 7, 2000

Office of the Comptroller of Currency
Docket No. 00-06
Communications Division
Third Floor
250 E Street, SW
Washington, DC 20219

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

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

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

Dear Madam and Sirs:

The North American Asset and Liability Management Association (NALMA) appreciates the opportunity to comment on the Agencies' "*Risk Based Capital Standards; Recourse and Direct Credit Substitutes; Proposed Rule*" (the Proposal). NALMA is comprised of 25 practitioners and consultants in the fields of asset / liability management and economic capital allocation. Membership is largely composed of US and Canadian financial institutions who are affected by the proposal in several ways: (1) as securitiziters of bank assets, (2) as sponsors of asset-backed commercial paper (ABCP) conduits, and (3) as investors in asset-backed securities. Our response represents the opinion of the collective group, and does not represent the opinion of any individual financial institution.

Our response is organized so that comments about the Proposal in general are presented first followed by comments regarding specific portions of the rule.

General Comments

NALMA supports the Agencies' efforts to more closely align the risk-based capital requirements with the true economic credit risk of financial transactions. However, we find the proposal to change the risk-based capital rules with respect to recourse and direct credit substitutes too narrow in scope when compared with the risk-based capital allocation methodology changes contemplated by the Basel Committee's consultative paper, *A New Capital Adequacy*. The proposed rule's focus only on asset-backed securities, recourse, and direct credit substitutes perpetuates the "one size fits all" approach applied to the measurement of credit risk and the assignment of risk-based capital to an institution's loan portfolio, which is home to the lion's share of credit risk. Such an approach that focuses on only one area of credit risk continues to incent banks to engage in risk-based capital arbitrage and slows the ultimate goal of aligning risk-based capital with economic capital and the true assessment of risk.

Advanced practice banks have developed sophisticated modeling techniques to measure and manage their credit risk exposures. Similar models, such as CreditMetrics and KMV, are also available publicly to all institutions. These models provide a quantitative assessment of credit risk that is driven by the probabilities of obligor default and the level of potential losses once default occurs. A critical input to the models is the evaluation of a borrower's default probability, which is directly linked to the internal risk rating assigned to the customer. Consequently, an internal ratings based approach should be adopted across all balance sheet categories; a bank's own ratings capture a finer level of detail than rating agencies or broad asset risk rating classifications. While we understand and applaud the Agencies move towards the use of internal risk-based models, we feel that the process of applying this approach in a piecemeal fashion and not in a comprehensive manner—covering all credit-risk portfolios—continues to incent institutions to engage in further regulatory capital arbitrage.

We feel strongly that a full model, internal ratings based approach is ultimately the best solution for aligning risk-based capital levels with the perceived risk for all asset classes. However, if the Agencies are intent upon proceeding with the rules as written, then we offer comment below on specific sections of the Proposal. We would like to see these changes implemented as an *interim step* towards a full model-based approach.

Proposed Treatment for Rated Positions

As stated earlier, we strongly favor the use of an institution's internal risk ratings as the standard for assessing risk-based capital requirements. If the Agencies intend to proceed

with the proposed changes that create a multi-level ratings based approach to measuring credit risk and allocating capital—all steps in the right direction—we believe that the number of risk segments is too limited to accurately align risk with capital. While we understand the need to balance accuracy against ease of administration, most advanced practice banks are assessing and managing risk at a much more granular level. At a minimum, there should be two additional risk buckets, separate the highest investment grade bucket into two, "AAA" and "AA", and add a category for "B-rated" assets. Significant differences in risk warrant the addition of these two classes.

We would also propose a reduction in the risk weights for the better-rated buckets to more closely align with their actual default experience. As the proposal currently stands, an AAA-rated security would be treated as a 20% risk-weighted asset, which at an 8% level, would translate into a capital requirement of 1.6%. This result seems to be in conflict with banks' internal assessment of risks and external rating agency data. Moody's recent special comment on default rates shows that over the period of 1970-1999, 1-year default rates for Aaa-rated bonds are 0.00% in each year[1]. In fact, their study shows that the average, 2-year cumulative default rate is 0.00% over the period 1920-1999. Even with a 100% loss rate, this translates into minimal capital.

Similar experience exists for the second highest bucket, i.e., AA-rated bonds. Moody's default study shows that Aa-rated bonds have an average 1-year default rate of 2 basis points during the period 1970-1999 and 8 basis points average for the period 1920-1999.

Actual experience suggests the proposed risk weights materially overstate the capital needed for high-rated obligations. Consequently, if the proposal were going to continue grouping the two highest investment grades together, we would suggest a risk weighting of 5%.

Also, we suggest that clarification of the range of ratings intended to be included in each category be specifically stated to avoid uncertainty. For example, we would like confirmation that BBB- is considered part of the lowest investment qualifying for a 100% risk weighting. This would also be more consistent with the Basel Committee proposal.

<u>Ratings on Non-traded and Un-rated Positions</u>

C.1 *Ratings on non-traded positions.* We feel strongly that a non-traded position should also qualify for an internal ratings-based approach. However, while subordinated pieces sold privately generally receive ratings from two different rating agencies, these ratings are not publicly available. There is generally no need to publish or allow the rating agencies to publish ratings on subordinated credit

[1] Source: Moody's Investors Service Special Comment *"Historical Default Rates of Corporate Bond Issuers, 1920-1999"*, January 2000

card classes sold privately. This information could be made available to regulators upon request to support an institution's capital position.

We agree with the removal of the fourth requirement that at least one position in the securitization be traded.

C.2 *Use of banking organizations' internal risk ratings.* As we have recommended many times in our response, internal risk ratings and credit-risk models are the appropriate way to measure credit risk and much preferable to the Proposal's arbitrary approach, which fails to address the largest source of credit risk, an institution's loan portfolio. Advanced practice banks have developed sophisticated ratings systems designed to assess loss potential and manage credit risk. The regulatory agencies are familiar with these processes through their periodic examinations of a financial institution's credit process. It seems illogical to us for this expertise, developed over the years, to be supplanted by a use of ratings agency methods, whose underlying framework and detailed parameterizations are not accessible to the Agencies.

We strongly agree that a revocable line of credit should not be considered a direct credit substitute. Such lines are often extended to asset-backed commercial paper conduits (ABCP) and are usually intended to provide back-up liquidity in the event of a disruption of the commercial paper market. It should be noted that even during the volatile market conditions in the fourth quarter of 1998 as well as the period leading up to and through Y2K, no liquidity draws occurred in the market.

The structures inherent in the ABCP market also beg for an internal ratings based approach. To effectively manage the risks, market participants have developed sophisticated internal grading and monitoring systems that reflect and measure the credit exposure of individual ABCP conduits. As you know, ABCP conduits are highly structured, highly collateralized vehicles designed to be very low-risk to the CP buyers and credit support providers. Some of the many structural alternatives available to reduce potential risks include:

- Bankruptcy remoteness,
- Over-collateralization,
- Frequent pool reporting,
- Ability to control collections, and
- Termination events that allow for liquidation of the asset pool.

These structures are designed to cover both expected and unexpected losses as determined by modeling the impact of stress scenarios on the performance of the collateral pool. This in turn drives the resultant risk rating. A very low level of historical loss experiences demonstrates how well the process has worked.

We recommend removal of the ninth criteria for using internal risk rating systems. It will be difficult to prove conformance with rating agency assumptions, as rating agencies generally do not share their assumptions and methodologies with their clients. Even if the rating agencies' processes were transparent, what level of conformity is appropriate, i.e., 100 percent, 80 percent, etc.

A qualifying internal risk rating system to apply the ratings-based approach to the banking organization's unrated direct credit substitutes should be extended beyond asset-backed commercial paper programs. Without this option, unrated subordinate asset classes would have to obtain two ratings solely to avoid the gross-up treatment, similar to the commercial paper conduits. The adoption of an internal ratings based approach for asset-backed securities; recourse and direct credit substitutes could serve as a proving ground for a broader implementation of an internal ratings-based approach to all asset classes and their risks.

Managed Assets Approach

There is substantial enhancement provided to the investors as required by the rating agencies to adequately protect the investor against dilution of his investment. When an early amortization begins, the enhancements are used to make payments if shortfalls exist. There is no additional credit risk to the issuing institution unless the issuing institution retains some of these enhancements (i.e., spread accounts or cash collateral accounts). If these types of enhancements are held by the issuer, these assets are already risk weighted at 100% and capital is held against these assets subject to the low level recourse rules.

It is unclear to us whether credit risk or liquidity risk is the purpose behind the Agencies' proposal to attach a 20% risk weight to securitized assets that are affected by early amortization triggers. Capital is determined largely with the results of our internal risk models, which are generally based on the standard framework of customer default probability and loss given default. Therefore credit-risk capital is already assessed through the recourse process.

Liquidity is one of the major benefits provided by the securitization of assets. It allows banks to access a different investor base and maturity sector than they regularly tap. This improves their overall liquidity profile because it increases the diversity of funding sources. The early amortization of a few credit card and CLO structures has undeniably shown a certain amount of liquidity risk is inherent with revolving structures. However, not all of these amortization events were triggered by credit events. Two CLOs (LTCB-Platinum and Swissbank Glacier) amortized because the issuers chose to let the structures mature for non-credit related events. As credit risk is already captured through the methodology described above, we believe it is inappropriate to target just master trust vehicles for liquidity risk charges rather than considering an organization's entire liquidity risk profile/management process. Requiring incremental capital for

securitizations with early amortization features may reduce the future use of this funding vehicle and potentially account for risk that is already managed through other methods.

The Proposal's managed assets approach requires capital to be held against "the potential credit and liquidity risks stemming from the early amortization provisions of revolving credit securitization structures." We fear this is a potential "double count" of liquidity risk and technically, there is no credit risk to the issuing institution as a result of early amortization provisions. Banks with significant dependence on the wholesale funding markets, including securitizations, have established strong liquidity risk management cultures, measures, and controls. One of the factors considered when managing liquidity risk is the potential funding needs arising from an early amortization event and unexpected draws under previously authorized lines of credit. These contingencies are incorporated into an institution's liquidity management process. Therefore, assessing capital in addition to the other actions used to manage this risk (i.e.: holding liquid assets), would impose an extra, unneeded cost. Also, this would be the first time liquidity risk attracts an explicit capital charge, opening a veritable "Pandora's Box" for a risk that is better managed and mitigated through other more effective and time-honored means.

Consequently, we oppose any capital charge for potential liquidity risk that could stem from securitizations of revolving credits that include an early amortization feature.

The following paragraphs respond to specific questions in the proposal and the alternative measures provided are intended to be move us closer to the full-model based approach.

Q1: What is the purpose of early amortization? Early amortization features exist to protect the investors from a deteriorating portfolio and ultimately any loss on their principal investment. In the event that performance deteriorates to a level that triggers an early amortization, investors will be paid out immediately rather than on their stated expected final maturity. Investors may receive less interest than they would have received if the securities were outstanding until maturity. The investor also has reinvestment risk upon early termination of their securities. However, substantial enhancement exists to ensure repayment of the investors' principal amount.

Q2: What are the potential effects on industry practice? Historically, there have only been a few master trusts that have experienced early amortization. The probability of early amortization occurring for most institutions is extremely remote. Thus, an additional regulatory capital burden resulting from a 20% risk weight on managed assets is disproportionate to any risk that an organization may retain. As a result, certain institutions may be less inclined to securitize for the wrong reason.

In addition, we believe that adoption of the proposed rules by the U.S. regulators before it can be enacted on a global basis may place U.S. banks at a competitive disadvantage with non-U.S. institutions that engage in asset-backed issuance and asset-backed commercial paper activities. Four of the top ten ABCP program

administrators are foreign financial institutions[2] who, if we understand the proposal, will not be subject to a potential increase in capital.

Q3: What are some possible alternative measure that would address more effectively the risks arising from early amortization provisions in revolving securitizations? Greater public disclosure would be a better measure to address risks of early amortization. However, greater public disclosure of credit card securitization performance is not necessary, as this information is already widely publicly available. In addition to monthly 8K filings of trust performance by series with the SEC, monthly performance by series is provided to and made available by Bloomberg. In addition, the majority of the investment banks track issuer portfolio performance. There are numerous research materials published by the investment banks monthly, which include this performance data. All of the relevant information, including trigger levels, is already available in one or more forms.

Another means to assess early amortization risk is through the use of internal risk models to determine the probability of an early amortization event occurring. In the event that specified triggers fall below certain levels, as deemed appropriate for each asset class, regulators may wish to evaluate the alternate liquidity plans of the financial institution at that time since the risk of early amortization is greater. Many institutions already perform this type of stress analysis as an integral part of their liquidity risk management process. Again, this gets into the area of liquidity and away from credit risk. These analyses could provide the regulators with a method for more dynamic and accurate assessment of capital adequacy that does not use a "one size fits approach" or a 20% risk weight.

NALMA agrees that existing securtizations should be exempt from the new rules if they require an increase in risk-based capital, but included under the new rule as of the date of adoption if there is a corresponding decrease in capital required. Although the Proposal is not clear, we would recommend that this exemption apply to all issuances from master trusts established **before** implementation of any rule changes. We also agree that the existing rules should be available for ABCP for up to two years after the effective date of any final rule to allow for implementation.

Again, NALMA appreciates the opportunity to provide the Agencies with its views on such an important topic. We would be happy to answer any questions or provide further thoughts on this issue.

Respectfully,

[2] Source: "Moody's Fourth Quarter 1999 ABCP Market Review"

H. Walter Young
NALMA President