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Citigroup Treasury

To: Manager, Dissemination Branch,
Records Management and Information Policy
Office of Thrift Supervision
Attention Docket No. 2000-15

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From: Hugh Van Deventer

Date: June 6, 2000

Fax: 212-793-5629

Re: Response Letter to Proposed Recourse
And Direct Credit Substitute rules

Phone: 212-559-0148

No. of Pages (including cover): 4



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June 6, 2000

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Ladies and Gentlemen:

We are writing this letter in response to the Joint Notice of Proposed Rulemaking published in the Federal Register on March 8, 2000 relating to the Risk-Based Capital Standards; Recourse and Direct Credit Substitutes (the "Release"). Citigroup is pleased to be a part of the comment process.

Citigroup supports making appropriate revisions to the rules for assessing risk-based capital in connection with securitization activity. We strongly agree with the basic principle of the Release, which we interpret as moving toward a system of assigning regulatory capital on the basis of the risk inherent in a specific securitization position. Citigroup supports the methodology described in the Proposed Treatment for Rated Positions and for Non-Traded Positions. However, we have two serious reservations with the respect to the Proposed Treatment of Unrated Positions and the Managed Assets Approach.

- First, the regulators should not favor the judgment of a rating agency over the judgment of a regulated institution in assigning risk-based capital. As currently drafted, the Release would not allow a qualified internal rating system to assign a risk weight of 20% or 50% to a securitization position. Only a securitization position rated "AA" or better or "A" by a rating agency could be assigned a risk weight at these lower rates.
- Second, the managed assets approach which assigns a 20% risk weight to any securitization that includes an early amortization feature should not be included in the final rule.

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Internal Rating Systems. Citigroup strongly believes that the regulators should fully accept internal rating systems assuming such systems are "qualifying." A traditional area of bank expertise is in evaluating credit risks and determining credit losses with respect to a particular asset class. Bank internal models are used to underwrite loans, to determine reserve levels and, in many cases, bank internal models are at least as sophisticated as rating agency models for predicting losses on pools of assets. The factors of an adequate internal risk weighting system are identified in section C-2 of the Release. From Citigroup's perspective these factors are sufficiently rigorous and objective so that once a regulator deems a particular system "qualifying," then such qualifying internal rating system should be capable of justifying a 20% or 50% risk weight to a particular securitization position. Citigroup strongly favors full application of internal rating systems in allocating regulatory capital.

Managed Assets Approach. Citigroup strongly disagrees with the managed assets approach outlined in Section D of the Release. Before analyzing the concerns expressed in the Release, we will briefly review the purpose of early amortization features in securitizations with revolving assets. The defining feature of a revolving securitization is that as a particular receivable is paid down a new receivable is sold to the investor. The sale to the investor of an interest in a pool of revolving assets is a combination of the purchase of an existing asset with the conditional promise of the investor to purchase a future asset. The most important of such conditions is that pool performance remains at satisfactory levels. The purpose of early amortization features in revolving securitizations is to determine if the conditions surrounding the promise to purchase future generated assets have been fulfilled, and, therefore, if such assets can in fact be purchased by the investor.

It should be noted that for regulatory capital purposes, banks only hold capital against current assets and certain off-balance sheet exposures. The future generated asset is akin to an unconditionally cancelable line of credit, and unconditionally cancelable lines of credit do not, and should not attract a regulatory capital charge. See Section A-3 of the Release.

The Release identifies three concerns raised by the presence of early amortization features in revolving securitizations. We will respond to each in turn.

"First, the seller's interest in securitized assets is effectively subordinated to the interests of investors by the payment allocation formula applied during early amortization."

The typical payment allocation formula would allocate principal payments to the investor by multiplying total principal collections by a fraction, the numerator of which is the investor interest in the asset pool prior to the beginning of the amortization period and the denominator of which is total principal in such asset pool. The effect of this allocation formula is that as the investor interest in the pool of assets declines, the investor is still allocated principal as if his share had not declined. The purpose of fixing the investor interest for principal allocation purposes is to avoid the arithmetical problem that if the numerator declined as the investor's interest in the pool declined the last dollar of principal to the investor would never in fact be paid out.

However, losses are allocated to the investor based on the investor's current interest in the pool of assets and payments of principal to the investor are limited to the investor's current interest in the pool of assets. While the investor's interest in the pool of assets is outstanding, the investor does in fact share on a pro-rata basis credit risk in such pool.

Because the investor has only conditionally promised to buy future generated assets, the fact that the typical early amortization principal allocation formula results in the seller being exposed on an accelerated basis to credit losses with respect to these future generated assets is not equivalent to saying that the seller is effectively subordinated to the interests of the investor.

"Second, early amortization can create liquidity problems for the seller."

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As is recognized in Section A-5, the Release is focused on credit risk, and other risks are to be addressed by other initiatives of the Agencies. We agree that, within the context of rules related to recourse and direct credit substitutes, a capital charge should be assessed only against arrangements that create exposure to credit or credit related risks. Citigroup respectfully suggests that because the Release is focused on credit risk, that the managed assets approach is not needed. Specifically, liquidity concerns should be dealt with in the context of a regulator's normal supervisory review of liquidity at any specific institution.

"Third, the first two risks to the seller can create an incentive for the seller to provide implicit recourse—credit enhancement beyond any pre-existing contractual obligation—to prevent early amortization."

If the managed asset approach were to be implemented, it would amount to a regulatory presumption that, because factors exist that might encourage any particular seller to provide implicit recourse, then all sellers will be assumed to be willing to provide implicit recourse. As is recognized in Section A-6 of the Release, the general policy is to address implicit recourse on a case-by-case basis, guided by the general rule that actions taken that demonstrate retention of risk will trigger recourse treatment of the affected transaction. Citigroup sees no compelling reason why an early amortization provision in revolving transactions, in and of itself, should justify a departure from this declared policy. We firmly believe that concerns about implicit recourse be dealt with on a case-by-case basis.

Citigroup appreciates this opportunity to comment on and address the proposals set forth the Release. We would be pleased to discuss further any questions that the Agencies may have with respect to our comments and recommendations.

Sincerely,

Peter Gallant