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Sent: Thursday, June 08, 2000 7:53 AM
To: 'regs.comments@occ.treas.gov'; 'comments@fdic.gov';
'public.info@ots.treas.gov'
Cc: MCCOOL, WILLIAM J; JACOBS, DOUGLAS L; McQuade, Eugene M
Subject: FleetBoston's Response to the Proposed Rule on Recourse &
Direct Credit Substitutes
Importance: High

Ladies and Gentlemen:

Attached is FleetBoston's response to the proposed changes in the risk-based capital standards for recourse and direct credit substitutes.

If you would like to discuss our comments further or need another information, please contact:

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Regards,
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Attachment
<<rbccomment9.doc>>



Fleet

FleetBoston Financial

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:

FleetBoston Financial (Fleet) appreciates the opportunity to comment on the Agencies' "Risk-Based Capital Standards; Recourse and Direct Credit Substitutes; Proposed Rule" (the Proposal). Fleet, with assets in excess of \$185 billion, is affected by the proposal in several ways:

- as a securitizer of bank assets,
- as a sponsor of asset-backed commercial paper (ABCP) conduits, and
- as an investor in ABS securities.

Our response is organized to first address the Proposal in general. Comments regarding specific portions of the Proposal follow.

General Comments

Fleet supports the Agencies' efforts to more closely align risk-based capital requirements with credit risk. However, we find the revision of the risk-based capital rules with respect to recourse and direct credit substitutes too narrow in context 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 on asset-backed securities, recourse and direct credit substitutes perpetuates the "one size fits all" approach in the measurement of credit risk and the assignment of risk-based capital for an institution's loan portfolio, which is where the bulk of the credit risk resides. Such an approach 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 approaches to measure, manage, and mitigate (as appropriate) risk across all asset classes and risk types. 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 a default occurs. A critical input to the models is the evaluation of a borrower's default probability that 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. Internal models capture a finer level of detail than rating agencies or broad asset risk rating classifications. While we concur with 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 this Proposal, 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.

A. Definitions and Scope of the Proposal

Direct Credit Substitute and Subordinated Interests in Loans or Pools of Loans. There appears to be an inconsistency in the treatment of purchased subordinated interests in the proposal as currently written. The proposed definition of a direct credit substitute includes purchased subordinated interests (section A. 2.). However, in the proposed definition of subordinated interests in loans or pools of loans, the following sentence seems to contradict the earlier treatment of a direct credit substitute: "The proposal would mitigate the effect of treating purchased subordinated interests as recourse by reducing the capital requirement on interests that qualify under the multi-level

approach..."(section A. 7.) This implies that purchased subordinated interests are to be treated as recourse, the effects of which would be mitigated under the multi-level approach. We request that there be clarification of the intended treatment for these assets.

B. Proposed Treatment for Rated Positions

The proposed changes that create a multi-level ratings based approach to measuring credit risk and allocating capital are a step in the right direction, however, we believe that the number of risk segments is too limited to more 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 like to propose a reduction in the risk weights for the better-rated buckets to more closely align with their actual default risk experience. As the proposal currently stands, a 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. Drawing upon surveys of banks undertaken by RMA for their response to the BIS capital proposal, the median, 1-year capital requirement was 43 basis points with a 90-100% loss given default (LGD)¹ for credits mapping to AAA and AA. Moody's recent special comment on default rates shows that over the period of 1970-1999, 1-year default rates for Aaa-rated bonds averages 0.00%². In fact, their study shows that the average, 2-year cumulative default rate is 0.00% over the period 1920-1999.

Similar experience exists for the second highest bucket, i.e., AA-rated bonds. Moody's default study shows that Aa-rated bonds showed 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.

Both sources suggest the proposal 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

¹ Source: "Response to the Basel Committee's Consultative Paper on A New Capital Adequacy Framework" by Robert Morris Associates, March 30, 1999

² Source: Moody's Investors Service Special Comment "Historical Default Rates of Corporate Bond Issuers, 1920-1999", January 2000

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.

C. Ratings on Non-traded and Unrated Positions

1. *Ratings on non-traded positions.* We feel strongly that a non-traded position should also qualify for a 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 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.

2. *Use of banking organizations' internal risk ratings.* 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.

Historical data strongly supports the high credit quality of ABCP securitization transactions. Even in the event of default, the ultimate LGD is very low. Receivables and other assets that convert into cash effectively secure ABCP transactions and therefore LGD is significantly reduced relative to other forms of credit extensions. These structures are highly structured, highly collateralized loans, where lending is done on a formula basis (e.g. an advance rate) against collateral and are further enhanced by the structural protections found in securtizations. Other protections include:

- Bankruptcy remote structures.
- Frequent pool reporting requirements.
- Termination events that allow for the liquidation of the asset pool.
- Ability to control collections.

Market experience to date indicates that draws have been rare and ultimate losses have been extremely low.

Based on the historically low losses in securitizations, there is concern that the proposed risk weights substantially exceed the amount that is justified by the credit risk inherent in securitization positions.

Neither program credit enhancement nor liquidity facilities should be in a first loss position since this is virtually always assumed by the customer through over-collateralization, recourse, or some other form of credit protection. The level of credit protection varies based upon the characteristics of the receivables pool. Generally the level of credit protection is sized to cover both expected losses as well as unexpected losses based upon modeling of stress scenarios.

Fleet, as an active participant in the Multi-Seller Conduit marketplace has developed internal systems for grading and monitoring the credit risk of each securitization to which they are a party. We strongly support the ability to utilize this sophisticated framework in order to support appropriate capital allocations.

We recommend deletion of the ninth criteria for using internal ratings in risk-based capital determinations. Rating agencies generally do not disclose their assumptions or methodologies, so it would be difficult to comply with this test.

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.

D. 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. Internally, we allocate capital for credit risk on a managed assets basis, as the first-loss position generally resides with the selling institution. 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

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 institutions³ 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.

Information on the collateral and loss performance of CLO's is less standardized but is also widely available through quarterly investor reports, Bloomberg, and investment banks web sites. We believe that, over time, disclosures of CLO performance will become standardized and will mirror the level of disclosure currently found in the credit card industry.

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. This would provide a basis to accommodate the likelihood of early amortization and not unduly penalize those portfolios where trust performance is healthy, specified trigger levels are in excess of those levels which would cause early amortization events to occur, and the risks of other pay-out event triggers are remote.

³ Source: "Moody's Fourth Quarter 1999 ABCP Market Review"



Fleet 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. Specifically, the exemption should 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.

Once again, Fleet appreciates the opportunity to provide the Agencies with comments on such an important topic as the proposed regulatory capital treatment of recourse and direct credit substitutes. If you would like to discuss our comments in further detail, please contact William McCool at 617•434•7701 or William Schomburg at 617•434•6158.

Respectfully,

/s/ Eugene M. McQuade

Eugene M. McQuade
Vice Chairman and Chief Financial Officer