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-----Original Message-----
From: sthompson@bondmarkets.com [mailto:sthompson@bondmarkets.com]
Sent: Wednesday, June 07, 2000 4:56 PM
To: public.info@ots.treas.gov
Cc: lgonzalez@bondmarkets.com; gmiller@bondmarkets.com
Subject: FFIEC Proposals Regarding Risk-Based Capital Standards - Docket
N o. 2000-15

Attached please find The Bond Market Association's response to the proposed
FFIEC regulations regarding risk-based capital standards. A hard copy will
follow via Federal Express. Please do not hesitate to contact George Miller
at 212.440.9403 or Laura C. González at 212.440.9454 regarding the attached.

<<FFIEC Comment Letter - final.doc>>

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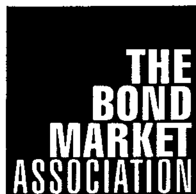

June 7, 2000

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

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve
System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Docket No. R-1055

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

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

Re: Proposed Revisions to Capital Standards Governing Recourse Arrangements and Direct Credit Substitutes

Ladies and Gentlemen:

The Bond Market Association (the "Association")[1] is pleased to respond to the above-referenced proposals (the "Proposals") issued jointly by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision (collectively, the "Agencies") for the purpose of revising the Agencies' risk-based capital standards applicable to recourse obligations and direct credit substitutes that expose banking organizations to credit risk.

The Association's membership includes banks and securities firms that are active in a

[1] The Association represents securities firms and banks that underwrite, distribute and trade debt securities, both domestically and internationally. The Association's member firms account for in excess of 95 percent of all primary issuance and secondary market trading activity in the U.S. debt capital markets. Among other roles, the Association's members act as issuers, underwriters, dealers and investors in securitized instruments. The views expressed in this letter are based upon input received from a broad range of Association members who are active in these markets, including members of various committees within the Association's Mortgage and Asset-Backed Securities Division. More information about the Association and its members and activities may be obtained from the Association's website at www.bondmarkets.com.

wide range of asset securitization[2] activities. Our members are directly affected by the Proposals. Association member firms both use and provide recourse and direct credit substitutes, through transfers of assets and the provision of credit enhancement in connection with asset securitizations. Our broker-dealer members provide investment banking, securities underwriting and distribution services to financial institutions and other organizations that engage in asset securitization activities. The Association's bank members both issue and underwrite asset-backed securities. They are also major institutional investor participants in the asset-backed securities markets. Accordingly, the regulatory capital treatment of recourse arrangements and direct credit substitutes significantly impacts the Association's membership, as well as the efficiency, depth and liquidity of the asset-backed securities markets.

Given the relevance of these issues to our membership, the Association has a longstanding and continuing interest in regulatory capital proposals issued by the Agencies, having commented extensively on the Agencies' 1994[3] and 1997[4] proposals (the "1994 Proposals" and the "1997 Proposals", respectively) concerning the risk-based capital treatment of recourse arrangements and direct credit substitutes. We appreciate the Agencies' continuing effort to address this important area of regulation, as well as their individual and collective responsiveness to many of the comments provided by the Association and other market participants in prior rulemaking initiatives.

Overall, the Association agrees with the objectives stated by the Agencies which have guided this multi-year regulatory effort: to develop risk-based capital requirements that (a) more closely reflect a banking organization's credit risk, (b) apply more consistent risk-based capital requirements to transactions involving similar credit risk, and (c) result in a more consistent treatment of "recourse" obligations and "direct credit substitutes" among the Agencies.

The Association appreciates the complexity associated with developing risk-based capital requirements which effectively address these goals. However, the importance of engaging in a careful, deliberative and comprehensive regulatory process must be balanced against equally important market needs. Given the lengthy pendency of this rulemaking initiative as well as parallel international efforts underway to revise risk-based capital requirements applicable to securitization transactions,[5] the Association believes that there is a pressing need to implement revised risk-based capital regulations which establish a

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[2] For purposes of this letter, unless otherwise indicated, references to "asset securitization" and "asset-backed securities" encompass all forms of residential and commercial mortgage securitization, as well as non-mortgage asset securitization activities.

[3] 59 *Federal Register* 27116 (May 25, 1994).

[4] 62 *Federal Register* 59944 (November 5, 1997).

[5] *See* "A New Capital Adequacy Framework", a consultative paper issued by the Basel Committee on Banking Supervision of the Bank for International Settlements (June 1999) and "A Review of Regulatory Capital Requirements for EU Credit Institutions and Investment Firms", European Commission (November 1999).

more appropriate incentive structure and risk-based capital regime for securitization activities, given the investment, risk reduction and other benefits securitization provides to banks and the banking system, and which take into account the demonstrated performance record of securitized instruments. The Proposals do not, in our view, respond fully to these needs. However, even as risk management practices continue to evolve within the banking community, incremental steps should simultaneously be taken to rationalize the current system of risk-based capital regulation and supervisory oversight. Subject to the comments and recommendations set forth herein, the Association respectfully urges the Agencies to bring closure to the present rulemaking, which we regard as an appropriate and timely step in this direction.

EXECUTIVE SUMMARY

Without purporting to address all aspects of the Proposals, the Association addresses the following issues in this letter:

- External Ratings-Based Approach to Determining Risk-Based Capital Requirements

    - Although the implementation of an external ratings-based approach to determining capital requirements is a welcome development, simultaneous efforts should continue to be made to allow risk-based capital requirements to be based on banking organizations' own internal ratings and bank model approaches to credit risk analysis.

    - The Association supports the Proposals' application of a 20 percent risk weighting to securitization positions rated in the highest and second highest investment grade categories. These positions are appropriately grouped with other asset types that presently enjoy a 20 percent risk weight.

    - The Association also supports risk weight treatment of 50 percent for positions rated in the third highest investment grade category and 100 percent risk weight treatment for positions rated in the lowest investment grade category.

    - With respect to positions rated one category immediately below investment grade, the proposed risk weighting of 200 percent is unduly penal and should be reduced.

    - For positions rated below this level and unrated positions, the Association would accept the proposed "gross-up" treatment. However, any risk weight that is applied should not result in capital requirements that exceed 100 percent of the banking organization's expected losses on that position.

    - Risk-based capital requirements based upon external credit ratings should incor-

porate finer gradations between and among categories if capital requirements are to reflect actual differences in credit risk.

- The Association supports the elimination of the ratings benchmark, historical loss and modified gross-up alternatives set forth in the 1997 Proposals.

- The Association continues to support the availability of the external ratings-based approach with respect to "non-traded" positions.

- Alternatives to the External Ratings-based Approach

  - The Association supports the broader adoption and application of banking organizations' internal risk rating systems in determining regulatory capital requirements.

  - The Association supports the Agencies proposed use of internal rating systems with a view toward expanding that approach beyond the terms delineated in the Proposals. However, the Association urges the Agencies to (a) expand the availability of such an internal risk rating approach beyond unrated direct credit substitutes in asset-backed commercial paper programs, and (b) revisit the internal bank model approach set forth in the 1997 Proposals, and continue efforts to make such an approach as broadly available as possible.

- Managed Assets Approach

  - The Association opposes the Agencies' "managed assets" approach to securitization transactions that incorporate early amortization provisions. We believe that requiring sponsoring banking organizations to apply a 20 percent risk weighting to securitized, off-balance sheet assets in these circumstances is not appropriate, given the primary liquidity (rather than credit recourse) purpose of early amortization features. Moreover, we believe that a regulatory focus on disclosure practices, combined with case-by-case supervisory attention to the liquidity and related issues presented by securitizations that incorporate early amortization features, would constitute more effective and appropriate regulatory oversight.

DISCUSSION

I. The Association supports an external ratings-based approach to determining capital requirements, subject to certain modifications. The Association generally supports a ratings-based approach to the determination of capital requirements. However, such determinations should not rest exclusively on this ap-

proach[6]. Further, the Association recommends that the ratings-based approach be modified as described in this section, particularly with respect to (a) the risk weights applied to various categories of rated and unrated positions and (b) the number of risk weight categories which have been proposed.

A. Risk Weighting of Positions Carrying the Two Highest Investment-Grade Ratings

The Association strongly supports the proposed adoption of a 20 percent risk weighting for all traded securitization positions that possess a credit rating in one of the two highest rating categories from one or more nationally recognized statistical rating organizations. Given the historical credit performance of investment grade asset-backed securities[7], the significant reduction in capital risk weights for triple-A and double-A rated positions that would result from the adoption of the Proposals is well justified. Further, such risk weights would result in regulatory capital treatment that is comparable to FHA-insured and VA-guaranteed mortgage loans, Freddie Mac, Fannie Mae and Sallie Mae securities, and high quality non-agency securities backed by agency mortgage-related securities, all of which currently enjoy a 20 percent risk weight treatment. The adoption of this element of the Proposals would not only apply risk weights to securitization positions that are more consistent with the actual credit risk they present, but would also align the capital requirements applicable to such positions with those presently applicable to other positions that present a similar credit risk profile.

B. Risk Weighting for Other Rated Investment Grade Positions

Other positions carrying investment grade ratings should similarly receive risk weight treatment commensurate with the positions' relative credit risk, and should not be subject to capital requirements that may exceed the face value of the positions, as is currently the case. Accordingly, with respect to positions rated in the third and fourth highest rating categories, the Association supports risk weight treatment of 50 percent and 100 percent respectively.

Moreover, certain artificial distinctions that presently exist between similarly rated mortgage-backed and non-mortgage asset-backed securities should be eliminated. Given that the credit performance of traded investment grade mortgage backed securities is compa-

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[6] Alternatives to the ratings-based approach are more fully described in Section II, below.

[7] For example, in terms of non-agency residential mortgage-backed securities, from 1992 through late 1999, out of a total of 4,707 mortgage-backed securities classes rated by Fitch IBCA, representing $374.6 billion, only 36 classes, representing $78.12 million, have defaulted. Of these defaulted securities, only two (totaling $10.17 million) originally carried investment grade ratings; the remainder were single-B rated or double-B rated. The credit performance of the investment-grade, non-mortgage asset-backed securities sector is comparable. Out of more than 6,500 individual asset-backed tranches rated by Moody's from 1986 through late 1999, exceeding $1 trillion, there have been only two defaults.

rable to that of investment grade non-mortgage asset-backed securities, investment grade mortgage backed securities should not be subject to risk weight treatment which is less favorable than that applied to comparably rated non-mortgage asset-backed securities.

C. Positions Rated One Category Below Investment Grade

With respect to positions that are rated one category below investment grade, the Association is of the opinion that the proposed risk weighting of 200 percent is unduly harsh. Given the historical performance of asset-backed instruments, including those that are marginally sub-investment grade, the Association questions the need to apply such a punitive risk weighting to these categories of securities.

First, there is no evidence that the incremental credit risk presented by a position rated one category immediately below investment grade warrants a doubling of the risk weight applicable to the positions rated in the lowest investment grade rating category.

Second, a risk weight of 200 percent is inconsistent with (1) international banking regulatory initiatives, as reflected in the Basel Committee on Banking Supervision of the Bank for International Settlements 1999 Consultative Paper the ("Consultative Paper"), [8] as well as (2) the risk weight presently applied to comparably rated corporate securities.

In its Consultative Paper, the Basel Committee recommended that a risk weight of 150 percent be applied to positions rated one category below investment grade. Without advocating the application of a 150 percent risk weight, the Association notes the inconsistent capital treatment that would result from the adoption of the Basel approach, on one hand, and the Agencies' approach, on the other.

Moreover, a 200 percent risk weighting far exceeds the highest risk weight applied to corporate securities (100 percent). The Association urges the Agencies to treat comparably rated corporate, asset-backed and other securities similarly. Similarly rated securities, including international securitization tranches, domestic corporate securities, and asset-backed positions do not present measurably different credit risks, as suggested by the Proposals.

Third, a 200 percent risk weighting could in some circumstances result in capital charges in excess of expected losses in the event of default. The Association is of the opinion that a banking organization should not be subject to capital requirements which exceed 100

[8] In March 2000, the European Securitisation Forum of The Bond Market Association (the "Forum") responded to the Consultative Paper and to a corollary consultation document issued by the European Commission in November 1999 entitled "A Review of Regulatory Capital Requirements for EU Credit Institutions and Investment Firms". In its comment letter, the Forum commented on the effect that these proposals would have on the international asset-backed securitization market. For a copy of the Forum's comment letter, please visit the Forum's website at www.europeansecuritisation.com.

percent of the bank's expected losses.

D. Risk Weighting for Unrated Positions and Positions Rated More than One Category Below Investment Grade

With respect to unrated positions and those rated more than one category below investment grade, the Proposals would apply a gross-up treatment. The banking organization would consequently hold capital against the amount of the position and all more senior positions, subject to the low-level recourse rule.[9] The Association supports the gross-up approach; provided, however, that as an alternative, such positions should be eligible to be analyzed, in appropriate circumstances, pursuant to internal rating systems and internal bank models (such internal rating systems and internal bank models, collectively, "Internal Information Approaches"). Although the merits of Internal Information Approaches are discussed more fully in Section II below, the Association is of the view that where a reliable internal risk analysis is available, there is no justification for applying an externally determined high capital requirement that is not reflective of the position's actual credit risk.

The Association similarly supports the Agencies' proposal to allow banking organizations to rely on qualifying credit assessment computer programs that rating agencies or other third parties have developed for rating otherwise unrated direct credit substitutes in asset securitizations. We agree that allowing for the use of such "ratings software" would be particularly helpful and efficient for banking organizations having relatively limited involvement in securitization activities. However, for the reasons discussed in greater detail in Section II. A. of this letter, the Association would support the broader deployment of such ratings software than would be allowed under the Proposals (which would limit the use of such software to direct credit substitutes, only, and even then only to qualify for a risk weight of 100 percent or 200 percent).

E. Gradations of Risk Weighting

A larger issue raised by the application of a limited number of risk weights based upon categories of external ratings is that the number of gradations of external ratings set forth in the Proposal is insufficient. Consequently, relatively small downward rating movements may result in disproportionately higher capital requirements. For example, under the Proposals, a position rated double A would be subject to a 20 percent risk weight, but a position rated A+ would be subject to a 50 percent risk weight. Increasing the number of gradations within the proposed risk weight categories would allow for the assignment of risk weights which more closely reflect actual default probabilities.

[9] This rule provides that the dollar amount of risk-based capital required for assets transferred with recourse should not exceed the maximum dollar amount for which a banking organization is contractually liable.

There is ample market support for the use of finer gradations among categories, or "buckets", of credit risk. First, banking organizations that employ internal ratings approaches generally rely on a greater number of gradations than set forth in the Proposals to reflect finer levels of credit risk. Second, nationally recognized statistical rating organizations themselves employ finer gradations within the rating systems each has established. Finally, given that primary market participants such as banking organizations and NRSROs each use finer rating gradations than are reflected in the Proposals, the Association recommends that the Agencies adopt proposals which are more reflective of actual market practices and conventions.

II. Alternatives to the External Ratings-based Capital Approach to Determining Capital Requirements

Although the Association supports the implementation of the external ratings-based approach as one immediately available mechanism for establishing regulatory capital requirements, external ratings should not serve as the sole means of making such determinations. As entities which are primarily engaged in the business of assessing credit risk, banking organizations have continued to develop more sophisticated methods of internal analysis. Most banking organizations, particularly larger and more sophisticated institutions, presently utilize Internal Information Approaches to make business and economic assessments of credit risk. The legitimate need to mandate adequate capital reserves can and should be met in as efficient and effective a manner as possible. Expanding the availability of Internal Information Approaches in certain circumstances would accomplish these purposes, by allowing institutions to employ a gauge of credit risk which may be more accurate than external credit ratings.

A. Internal Ratings-based Approach

Many banking organizations currently use internal rating systems in assessing credit risk. The Proposals would permit a banking organization with a qualifying internal risk-rating system to rely on such internal ratings only in the case of direct credit substitutes in asset-backed commercial paper programs. Moreover, applicable risk weights capable of being established through the use of internal ratings in this context would be either 100 percent or 200 percent.

We recognize that the Agencies have proposed this limited use of internal rating systems as a step toward making such as an approach more widely available in the future. However, the Association urges the Agencies to broaden the applicability of this approach. We believe that even during this first stage of implementation, limiting the availability of an internal ratings-based approach to commercial paper programs alone -- and even then, allowing this approach to be used only to qualify for a 100 percent or 200 percent risk weighting -- is unnecessarily narrow. The Association believes that the conditions set forth in the Proposals describing adequate internal rating systems are reasonable and ob-

jective, and could be applied more broadly, beyond the asset-backed commercial paper context. We strongly encourage the Agencies to consider making this approach more broadly available, to any banking organization (with respect to any type of securitization position, and for any risk weight) that can demonstrate its ongoing compliance with the conditions set forth in the Proposals.

B. Internal Bank Model Approach

Internal bank models can provide an additional, and preferable, method of establishing capital requirements. Assessing credit risk through an internal model allows for more nuanced, and ultimately more accurate, assessments of credit risk. In the 1997 Proposals, the Agencies proposed, for consideration, an internal model approach; however, this approach was not carried forward in the current Proposals. As the Agencies noted in the preamble to the 1997 Proposals, "such a system would be broadly consistent with both the internal models approach to capital now being implemented for market risks associated with bank trading activities, as well as with current supervisory policies for evaluating the adequacy of the allowance for loan and lease losses."

Additional benefits of an internal bank model approach include the possibility that (1) a bank's internal risk assessment could effectively serve as a substitute for a credit rating, thus reducing the costs and delays associated with obtaining such a rating, (2) an acceptable internal model for measuring credit risk could form the basis for assessing capital requirements on a portfolio, rather than an asset-by-asset basis, thus better reflecting a banking organization's diversification, hedging and other risk management activities, and (3) the use of bank model approaches would also enable the Agencies to overcome some of the inherent deficiencies and limitations in a ratings-based approach, most significantly, by (a) placing appropriate reliance on the regulated institution, rather than an unrelated outside agency, for making informed judgements about credit risk and corresponding regulatory capital requirements, (b) eliminating the cost, administrative burdens and delays that may be associated with obtaining ratings (especially for recourse and direct credit substitute positions for which ratings are not typically sought or obtained at present) and (c) utilizing the capacity that internal models provide to establish finer gradations in regulatory capital requirements, and associated risk weights, for various positions along the credit risk continuum.

The Association acknowledges and endorses the establishment of high standards before an institution should be able to take advantage of an internal model based approach for determining capital requirements. As stated in the comment letter submitted by the Association in response to the 1997 Proposals, this approach should only be available to institutions with a demonstrated capacity to apply "sophisticated, comprehensive internal risk management techniques to measure credit and to establish appropriate capital reserves that adequately account for institution specific risks. Such institutions must be able to demonstrate that they have in place appropriate, policies, practices and procedures

to quantity and manage the credit risks that are associated with their asset securitization activities."

Nevertheless, we believe that the Agencies, in cooperation and consultation with international banking regulators, should continue simultaneously to pursue this approach, even as nearer-term adjustments and refinements (such as adopting an external ratings-based approached) to risk-based capital regulations are made.

III. Managed Assets Approach

As noted in the Executive Summary of this letter, the Association opposes the Agencies' proposed "managed assets" approach to securitization transactions that incorporate early amortization provisions. In our view, early amortization provisions (which are a standard feature in credit card and certain other revolving securitization transactions) represent a form of liquidity protection for bondholders, rather than constituting credit recourse to the banking organization that sponsors the securitization transaction. As such, we believe that any additional regulatory capital required pursuant to the managed assets approach would duplicate capital requirements already imposed on such sponsoring organizations for sales of assets with recourse.

Moreover, the specific terms and conditions of early amortization and similar liquidity provisions may vary among transactions, and may have different repayment priorities, structural features and operational characteristics. As a consequence, we do not believe that the imposition of a uniform capital treatment for all such provisions would be appropriate without a case-by-case examination of these differences.

We agree with the Agencies' acknowledgment that alternative measures may be more desirable than the imposition of a uniform 20 percent risk weight in dealing with any special risks or contingencies posed by early amortization features. The Agencies note that such measures might include enhanced public disclosure of securitization performance. In this regard, however, we believe that existing disclosure practices are adequate. Banks that securitize credit receivables in revolving master trusts are required, both by the governing documents for those transactions and by established market custom and practice, to provide monthly information to investors, rating agencies and other market participants that explicitly addresses factors bearing on early amortization risk. These data also constitute an appropriate base of information for use by banking regulators in supervising individual sponsoring organizations' management of early amortization risks and related contingencies. The Association believes that these disclosure and supervisory practices are adequately supported by the current level of information that is generated and made available by bank sponsors with respect to early amortization provisions, and that the continuation of such practices is preferable to instituting a new capital charge against "managed assets."

IV. Conclusion

The Association agrees with the Agencies' goal of aligning capital requirements more closely with actual credit risk. We believe that overall, the Proposals are an important first step in this direction. However, regulatory risk-based capital reserves should be required only to the degree that they are demonstrably necessary to provide an essential cushion against actual credit risk. Capital reserves required above this level are inefficient and undesirable, since the available supply and cost of capital that can be devoted to other, more productive applications are impaired, resulting in a misalignment of reserve requirements and credit risk. For these reasons, the Association believes it essential for the Agencies to continue working toward the adoption and application of Internal Information Approaches by regulated institutions themselves as ultimately a more effective and efficient mechanism for establishing regulatory risk-based capital requirements.

Consistent with the foregoing recommendations, the Association strongly encourages the Agencies to bring to fruition its significant efforts to improve the regulatory risk-based capital treatment of recourse obligations and direct credit substitutes in asset-backed securitization transactions.

Please contact the undersigned at 212.440.9403, or Laura González, Assistant General Counsel of the Association, at 212.440.9454 should you desire further information or clarification regarding the matters discussed herein.

Sincerely,

George P. Miller
Senior Vice President and
Deputy General Counsel

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