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Sent: Wednesday, June 07, 2000 5:16 PM

To: 'public.info@ots.treas.gov'

Subject: COMMENT

<<GEFFIEC2.pdf>>

I am sending GE Capital Mortgage Corp's comment on recourse and direct credit substitutes. Please confirm receipt if you have a procedure for doing so.

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June 7, 2000

By Facsimile, E-mail and Regular Mail

Docket No. 00-06
Communications Division
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250 E Street, SW
Washington, DC 20219
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Records Management and Information
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Office of Thrift Supervision
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Docket No. R-1055
Jennifer J. Johnson, Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, Dc 20551

Robert E. Feldman, Executive Secretary
Attn: Comments/OES
Federal Deposit Insurance Corporation
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RE: *Comment on Risk-Based Capital Standards:
Recourse and Direct Credit Substitutes*

Dear Sir or Madam:

On behalf of GE Capital Mortgage Corporation ("GECMC"), the residential mortgage insurance, lending and services affiliate of GE Capital, we are pleased to submit comments to the members of the Federal Financial Institutions Examination Council ("FFIEC") with regard to proposed revisions to risk-based capital ("RBC") requirements applicable to regulated entities for recourse and direct credit substitutes (the "Proposal"). As a global provider of residential mortgage loans and mortgage insurance ("MI") products and one of the largest issuers of mortgage-backed securities in the United States, GECMC has followed and commented on relevant issues raised by the consultative paper issued by the Basle Committee on Banking Supervision in June 1999 and the ongoing effort to apply RBC standards to Fannie Mae and the Federal Home Loan Mortgage Corporation. In each proceeding, GECMC's suggestions are intended to enhance credit risk reduction, operational efficiency, transparent supervisory review and market discipline for the regulated institutions. So, although GECMC is not regulated by any member of the FFIEC, we wish to comment on the Proposal in an effort to maintain some consistency of approach for lenders and investors engaged in residential mortgage finance.

We commend the FFIEC for the Proposal and urge rapid but thoughtful action on it. GECMC is particularly interested in three aspects of residential mortgage finance and credit risk-mitigation measures under the Proposal.

First, we strongly support the FFIEC's use of external ratings for RBC risk weighting purposes as a time-tested means of relating capital to economic risk. We believe in the straightforward concept of assessing risk based upon public ratings provided by national recognized statistical rating organizations ("Rating Agencies"), and we commend the FFIEC for recognizing the appropriate risk weighting for privately-issued, highly-rated mortgage-backed securities. However, the Proposal does not apply the concept of relating capital charges to economic risk as fully as it should. At the top end of the credit scale, the Rating Agencies have distinguished consistently between "AAA" and "AA" rated instruments and entities in recognition of the lesser default and ratings migration probability evidenced by a "AAA" rating. And, at the lower end of the credit scale within the context of structured transactions, default data drawn from Rating Agency experience suggest that the FFIEC has not accounted fully the economic risk of lesser-rated ("BBB-" and below) or unrated securities. Consequently, we urge the FFIEC to refine its ratings categories to (a) provide "AAA" rated instruments (and entities) more favorable treatment (and would propose a risk weighting of 10% for "AAA" rated assets), and (b) reconsider the greater economic risk present in lesser-rated or unrated securities (and would propose a reconsideration of whether "gross up" treatment or some other alternative is appropriate for these securities).

Second, consistent with our interest in relating capital to risk, the Proposal as adopted clearly should reflect the risks associated with structured mortgage loan products and stand-alone home equity loans. Subordinated interests expose the holder to a greater than *pro rata* exposure to loss, and the increased credit loss exposure should be reflected in RBC risk weightings. Further, we agree that there is no difference between subordinated interests whether retained or purchased. We believe that the Proposal is intended to characterize structured mortgage loan transactions (e.g., an "80/10/10," where the loan transaction includes an 80% loan-to-value first lien and a 10% LTV second lien) and stand-alone home equity loans as subordinated interests, which we support strongly. We respectfully request that the Proposal state explicitly that subordinated interests include all second mortgage liens whether retained, purchased, part of a structured transaction or a separate home equity loan, and all such interests are subject to recourse treatment. Otherwise, as we think the FFIEC has recognized, the RBC system will not reflect the risk of the subordinate interests and encourage arbitrage of the RBC standards. In addition, uncertainty regarding the appropriate risk characterization of these subordinate liens discourages the systemic risk transfer afforded by our "AAA" rated MI business, which currently receives this risk as it is exported outside the banking system.

Third, we support the proposed RBC treatment of credit derivatives, but believe that the final rule should state that credit derivatives related to securitized or transferred assets (which allows credit risk to be retained) should be treated as recourse. More generally, we believe as well that the Proposal (or a related rulemaking) should clarify systematically the relationship between the risk weighting of the credit-enhanced asset and the amount of the capital charge that must be held against the derivative obligation when the reference assets are not related to the guarantor. In terms of capital relief to the beneficiary of the unrated, non-traded credit derivative, the

current practice is to treat credit default and total rate of return swaps as similar to guarantees and give the credit-enhanced asset a 20% risk weighting based on the guarantor's status as an OECD depository (or 50% risk weighting if not qualifying for the 20% category). The Proposal introduces the use of ratings for rated, tradable instruments and alternatively allows the use of an internal ratings system for unrated, nontraded instruments. Since the Proposal includes credit derivatives as recourse or a direct credit substitute, we are unsure which risk weighting now applies – the traditional guarantor weighting, a weighting based on the external long-term financial strength or credit rating of the guarantor, or a weighting derived from application of the beneficiary's internal rating system. Together with adoption of the new 10% "AAA" risk weighting discussed above, we believe that a weighting based on the external long-term financial strength or credit rating of the guarantor is most appropriate. The "guarantor" rating does not assess counterparty risk individually, and the internal ratings approach (with its uniform 100% risk weighting for "investment grade") provides no incentive to seek the highest quality counterparty.

In addition, we note that the Basle Committee has proposed to require that guarantors have a proven ability to absorb risk, be regulated to ensure that they continue to do so, and meet market pricing and liquidity needs, among other factors. We monitor developments in the area of mortgage default risk and remain unconvinced that the credit derivatives being used or proposed as recourse or direct credit substitutes for mortgage default risk satisfy the Basle Committee's requirements – especially in comparison to MI products.

One final suggestion. The Proposal has evolved over a number of years, and regulated institutions, the capital markets and providers of credit enhancement to the regulated institutions continue to develop, introduce and refine new means of credit enhancement. The Proposal offers a solid contribution toward classifying the varieties of credit enhancement and their capital treatment. We suggest that the final result of this classification exercise be collected in a simple presentation that allows easy comparisons between capital burdens and benefits of each for regulated institutions. We have strong views regarding the value of MI as a credit enhancement for residential mortgage assets, but the Proposal should present all means of credit enhancement (whether structured transactions, letters of credit/guarantee, credit derivatives, spread accounts, over-collateralization, MI and retention of credit risk through recourse) in a manner that stimulates comparison, competition and, where appropriate, substitutability. Demystification of the various credit enhancement alternatives and relating capital charges to economic risk would be a significant accomplishment, and we believe that the Proposal is close to achieving these goals.

We would welcome an opportunity to discuss our comments with you and your colleagues.

Sincerely yours,

Eric Klopfer
Vice President and Senior Counsel

Michael F. Molesky
Vice President – Capital Markets

Comment

1. **The Proposal should be refined to include a risk weighting that rewards the use of “AAA” Rated Instruments and reconsider the treatment of lesser-rated or unrated Instruments.**

GECMC recognizes that the FFIEC (along with the Basle Committee) has wrestled with the question of whether and how to incorporate external rating opinions into bank and thrift RBC requirements. Many banks likely will continue to urge the FFIEC to increase the importance of internal models in the Proposal.¹ However this issue is resolved by the FFIEC, we urge that the final rule maintain consistent empirically-based relationships between RBC and economic risk – requiring, at the top end of the credit rating scale, a distinction between “AAA” and “AA” rated instruments and entities for risk weighting purposes and, at the lower end, a reconsideration of the risk weights (or risk weighting approach) proposed for lesser-rated (“BBB-” and below) and unrated subordinate securities that are created as part of a structured transaction.² We believe that the Proposal represents a substantial step in that direction.

As we noted, external ratings provide an empirically based means of relating capital to economic risk. Although the FFIEC recognizes this relationship, the Proposal does not follow the implications of this approach at either end of the credit scale as fully as it might. At the top end, the Proposal does not distinguish between “AAA” and “AA” rating categories despite the differences in default and ratings migration (or the probability that an entity or instrument will move up or (more importantly, in this case) down in ratings category, creating capital volatility) probabilities between “AAA” and “AA” rated instruments. Thus, we urge the Committee to

¹ We generally endorse the use of internal ratings models as set forth in the Proposal to reduce risk weightings to 100%, but would suggest development of a calibration mechanism (perhaps in conjunction with the Rating Agencies) to ensure comparability of internal assessments – perhaps, for example, through routine sampling, testing and comparison of randomly chosen internally rated instruments. The same rigor and interest in maintaining consistent relationships between RBC and economic risk is present in external ratings as well, and we recommend a similar periodic calibration exercise by FFIEC members.

² GECMC recognizes that one concern in relying on ratings is the power that this may give the Ratings Agencies or, alternatively, how their independent judgment might erode when subjected to pressure by powerful financial institutions within a ratings-driven regulatory system. Separately, the Ratings Agencies have expressed concerns regarding rating shopping, Rating Agency independence and innovation. We believe the current proposal addresses this by permitting banks to rely on ratings from any one of several Rating Agencies. However, the FFIEC should reduce the incentives to manipulate the ratings system by requiring at least two ratings, adopting the lower rating when an instrument is “split” rated, making ratings on non-traded instruments publicly available and periodically reviewing non-traded instrument ratings for sufficiency. We believe that growing reliance on ratings, in part due to RBC recognition of them, will spur growth and encourage new entrants in the ratings business, and this concentrated source of credit expertise represents a sensible means of monitoring credit quality within the bank regulatory system. Incorporating easily implemented protections and encouraging competition within the ratings business will significantly lessen any potential for the Ratings Agencies to use their influence in unintended or undesirable ways (including “up-“ or “down” grading instruments or entities for reasons other than objective risk factors). See Moody’s Investors Service, “Managing the Risks Implied by the Use of Ratings in Regulation – Special Comment,” (Oct. 1999); Standard & Poor’s Responds to Basle Committee’s Proposals (CreditWire: Jan. 1, 2000).

reconsider this issue and provide a new more favorable 10% risk weighting for “AAA” rated instruments.

Using an undifferentiated “AAA/AA” risk bucket has two significant shortcomings. First, in terms of simple risk concerns, “AAA” and “AA” rated instruments and entities unquestionably have different **and material** default and ratings migration probabilities, as Tables 1, 2, 3 and 4 demonstrate.

Table 1

Average Corporate Issue Default Rates By Rating By Number of Years Following Given Rating – 1920-1999								
Rating	Default Rates By Rating By Years Following Rating				Ratio of Default Rates By Rating to “AAA” Default Rates			
	5 Yrs.	10 Yrs.	15 Yrs.	20 Yrs.	5 Yrs.	10 Yrs.	15 Yrs.	20 Yrs.
AAA	0.20%	1.09%	1.89%	2.38%	1.00	1.00	1.00	1.00
AA	0.97%	3.10%	5.61%	6.75%	4.85	2.84	2.97	2.84
A	1.37%	3.61%	6.13%	7.47%	6.85	3.31	3.24	3.14
BBB	3.51%	7.92%	11.46%	13.95%	17.55	7.27	6.06	5.86
BB	10.04%	19.05%	25.95%	30.82%	50.20	17.48	13.73	12.95
B	20.89%	31.90%	39.17%	43.70%	104.45	29.27	20.72	18.36

*Source: “Historical Default Rates of Corporate Bond Issuers, 1920-1999”,
Moody’s Investors Service, January 2000*

As Table 1 demonstrates regarding general corporate bond issues, “AAA” corporate issuers have a significantly different and consistently better default record relative to “AA” issuers across all time periods. Specifically, “AA” rated issuers had long-term average default rates that are 3 to 5 times larger than that of “AAA” rated issuers.³

³ Although we discuss the default variability in below investment grade issues in greater detail below, the data in Tables 1 and 2 also clearly show that below investment grade issuers have significantly higher default rates than “BBB” and above issuers, which suggests that the 200% risk weighting for “BB” issues should be revisited as well. In terms of long run average corporate bond issuer 10 year cumulative defaults in Table 1, “BBB,” or the lowest investment grade rating, was 7.3 times more likely to default than “AAA” issues, and lesser rated issues were significantly worse (for “BB,” 17.5 times, and 29.3 times for “B”). In terms of “ratings migration” data for corporate bond issuers in Table 2, the probability of a “BB” falling to “CCC” was 4 times higher than a “BBB”. The probability of a “B” falling to “CCC” was 25 times higher than a “BBB”.

Table 2

Corporate Bond Average Rating Transition Matrix, 1980-1999									
	Rating to:	AAA	AA	A	BBB	BB	B	CCC	Probability AA or Higher
Rating From:	AAA	85.88%	9.76%	0.48%	0.00%	0.03%	0.00%	0.00%	95.64%
	AA	0.92%	84.87%	9.64%	0.36%	0.15%	0.02%	0.00%	85.79%
	A	0.08%	2.24%	86.24%	6.09%	0.77%	0.21%	0.00%	2.32%
	BBB	0.08%	0.37%	6.02%	79.16%	6.48%	1.30%	0.11%	0.45%
	BB	0.03%	0.08%	0.46%	4.02%	76.76%	7.88%	0.47%	0.11%
	B	0.01%	0.04%	0.16%	0.53%	5.86%	76.07%	2.74%	0.05%
	CCC	0.00%	0.00%	0.00%	1.00%	2.79%	5.38%	56.74%	0.00%
<p>Source: "Historical Default Rates of Corporate Bond Issuers, 1920-1999", Moody's Investors Service, January 2000</p>									

As Table 2 demonstrates, "ratings migration data" also reveal significant differences among rated corporate issuers even in normal economic times. Ratings migration risk is the likelihood of a ratings downgrade after the initial rating is established, which increases the volatility of risk weightings for particular assets. In terms of stability of rating categories:

- ◆ For upgrades in ratings, "A" rated companies are 2.43 times more likely to be upgraded to "AA" than "AA" being upgraded to "AAA" (2.24% ÷ .92%). In fact, the likelihood of a "AA" rated company being upgraded one rating class (to "AAA") is the least likely probability of any rating class receiving a one rating class improvement. This reflects the exceptional financial strength of "AAA" and the difficulty in achieving this most desired rating.
- ◆ For downgrades, "AA" rated companies are 20 times more likely to fall to "A" than a "AAA" rated company (9.64% ÷ .48%). The possibility of a "AAA" falling two rating categories is clearly a remote possibility.

Table 3 below presents ratings migration data for rated instruments in the form of structured finance residential mortgage-backed securities ("RMBS") since 1978. These data show that the differences between "AAA" and "AA" ratings are even more significant for these instruments than for corporate bond issuers.

- ◆ "AAA" rated RMBS have a zero ever-to-date default compared to the 1.47% default rate of "AA" rated RMBS.
- ◆ "AA" rated RMBS were 100 times more likely to fall below "AA" than "AAA" rated RMBS.

Table 3

US Residential MBS Rating Changes by Initial Rating 1978-1999										
	Rating To: (Across)	AAA	AA	A	BBB	BB	B	CCC	Ever-To-Date Default	Probability A or Higher
	AAA	99.13%	0.76%	0.00%	0.03%	0.03%	0.00%	0.03%	0.00%	99.90%
Rating From: (Down)	AA	16.90%	72.68%	6.68%	1.07%	0.13%	0.07%	1.00%	1.47%	89.58%
	A	2.07%	4.31%	87.76%	4.66%	0.17%	0.00%	0.00%	1.03%	6.38%
	BBB	0.42%	1.68%	4.19%	89.94%	1.47%	0.21%	0.63%	1.47%	2.10%
	BB	0.00%	0.00%	0.00%	0.84%	92.89%	2.93%	0.84%	2.51%	0.00%
	B	0.00%	0.00%	0.00%	0.41%	2.07%	88.84%	2.48%	6.20%	0.00%
	CCC	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	100.00%	0.00%	0.00%
<i>Source: "Performance of US RMBS Credit Ratings, 1978-1999", Standard & Poor's Rating Services</i>										

In addition, Table 4 demonstrates that "AAA" rated structured finance instruments carry 1.6 to 2.5 times more credit enhancement than that required for "AA" rated instruments, which helps to mitigate against default or downgrade.

Table 4

Standard & Poor's Credit Enhancement Levels For Residential Mortgage-Backed Securities (RMBS)				
		AAA	AA	Ratio: "AAA"/"AA"
LTV				
60		3.00%	1.20%	2.50
65		4.13%	2.00%	2.06
70		5.25%	2.80%	1.88
80		6.45%	4.00%	1.61
90		6.98%	4.35%	1.60
95		13.50%	8.10%	1.67
<i>Source: "Residential Mortgage Criteria", Standard & Poor's Structured Finance Ratings Group, November, 1999</i>				

Thus, "AA" rated companies and instruments are both more likely to default and get downgraded to "A" than "AAA" rated companies and instruments, so combining "AAA" and "AA" entities and instruments in a single risk-weighting category is not empirically supported.

Second, providing as broad a top risk bucket as proposed would create a perverse incentive for banks to obtain the lowest possible risk-mitigation protection within the top band. It is hard to see why a bank would credit enhance an asset to a "AAA" level or seek a guarantee from a "AAA" rated guarantor when its capital requirement would be no less than if only a "AA" credit enhancement were in place. Conversely, as a guarantor, it would be hard to justify the additional capital and other criteria needed to maintain a "AAA" rating when only a "AA" rating would suffice. Thus, combining "AAA" and "AA" rating categories would encourage precisely the same type of arbitrage created by the current broad risk buckets, where banks have an incentive to take on the riskiest loans because they bear no more capital in the 100% risk weighting category than top-quality assets.

Unsurprisingly, the capital markets understand this, and recognize and price each rating class differently. The price differentials are consistent with how the Rating Agencies evaluate both rated securities and individual companies.⁴ Combining “AAA” and “AA” into a single category will interfere with this pricing mechanism unnecessarily – and with potentially detrimental results – since RBC assessments will differ from long-term empirical results. **In view of the 3 to 5 times difference in magnitude of long-run average default rates between “AAA” and “AA” issuers, a reduction of the 20% risk weight to 10% for “AAA” rated issuers is a conservative recognition and justification of this difference.**⁵

The Proposal’s treatment of lesser-rated and unrated instruments within the context of a structured transaction deserves brief discussion as well, since the proposed RBC treatment might create similar unanticipated results at the lower end of the credit scale. We support the assessment of risk based on long-term observed differences between categories of risk, and the assessment should not create opportunities to disconnect the relationship between RBC and economic risk.

Unfortunately, the Proposal might create such a disconnection within the context of structured transactions where a pool of assets is divided into various rated and unrated categories based on default probabilities. Under the current RBC approach, the amount of capital required for holding all of the securitized pieces within the banking system is 4%. It would be logical to assume that the Proposal would require the same level of RBC as the current regulatory approach. However, substantially less capital is required under the Proposal for a structured asset-backed securitization, since only the “B” rated portion is “grossed up” (considered as part of the entire transaction, including senior interests, for RBC purposes). Thus, the Proposal reduces capital on the same assets through the alchemy of securitization even if the securitized pieces are not sold.

Part of this problem is caused by the capital requirements for “BBB-” and below securities, which are not proportional to average default rates of these securities compared to “BBB,”⁶ as is shown in Table 5 below, which compares long-run average cumulative default rates by rated securities by number of years following a rating.

⁴ In addition, in the US, the Office of Federal Housing Enterprise Oversight (the financial safety/soundness regulator for Fannie Mae and Freddie Mac) has proposed risk-weightings based upon external ratings that differentiates between “AAA” and “AA” in terms of counterparty discounts (10% for “AAA” over a 10-year period, and 20% for “AA”). We have submitted two comments in support of OFHEO’s proposed distinction. See www.OFHEO.gov (RBC Comments, especially GECMC Comment dated April 14, 2000 at pp. 2-16).

⁵ We would limit the “AAA” risk weighting to instruments and obligations guaranteed by entities that have been rated “AAA” by at least two Rating Agencies, and would not recommend inclusion in this category of “implied AAAs” such as those held by Fannie Mae and Freddie Mac. The “AAA” ratings given by the Rating Agencies to these entities rely heavily on judgments regarding the strength of the “implied government guarantee” (expressly disclaimed by statute) enjoyed by Fannie Mae and Freddie Mac. Stand-alone ratings performed by the Rating Agencies (admittedly, a somewhat metaphysical exercise) place Fannie Mae and Freddie Mac in the “AA” category, which is where the Proposal places them as well. See Note 2.

⁶ Ordinarily, “BBB” is not tranching further into “BBB+”, “BBB”, and “BBB-”, but doing so for the purposes of this example allows us to isolate the acceleration point for default probability. The data used in Table 5 are taken from Moody’s Investors Service Historical Default Rates of Corporate Bond Issuers, 1920-1999. All default rates except for further tranching of “BBB” have been taken from Exhibit 30, and the “BBB” tranching has been interpolated from Exhibit 31, which has a shorter time series (1983-1999), but is still appropriate for comparative purposes.

Table 5

Long-Run Average Default Rates and Relative Capital Requirements								
Rating	Long-Run Average Default Rates			Ratio of Average Default Rates to BBB Plus and BBB Default Rates			Proposed Capital	Relative Weights
	Level	One Year	Two Yrs	Three Yrs	One Year	Two Yrs		
AAA	0.00%	0.00%	0.02%	0.00%	0.00%	1.69%	1.6%	20%
AA	0.08%	0.25%	0.41%	67.88%	42.07%	34.70%	1.6%	20%
A	0.08%	0.27%	0.60%	67.88%	45.44%	50.78%	4.0%	50%
BBB, BBB+	0.12%	0.59%	1.18%	100.00%	100.00%	100.00%	8.0%	100%
BBB-	0.66%	1.63%	2.83%	563.64%	274.58%	239.29%	8.0%	100%
BB	1.43%	3.45%	5.57%	1213.33%	580.60%	471.45%	12.0%	150%
B	4.48%	9.16%	13.73%	3801.21%	1541.53%	1162.12%	100.0%	1250%

Table 5 demonstrates that the capital requirements of “BBB-” and “BB” rated securities should be increased significantly to preserve proportionality of capital to risk. For “BBB-” rated securities, depending on the length of time chosen, the appropriate proportional capital requirement should be between 2.5 and 5.6 times higher than the proposed 8% capital charge. For “BB” rated securities, depending on the length of time chosen, the appropriate proportional capital requirement should be between 3 and 8 times higher than the proposed 12% capital charge. We agree with the requirement for 100% capital for “B” rated and unrated securities given their riskiness.

Table 6

Required Capital on An Asset-Backed Structured Securities Under Various Proposals						
Rating Level	Tranche Distribution	Current Capital	Proposed Rule	Proposed Capital	GE Proposal	GE Proposed Capital
AAA	90%	3.60%	1.6%	1.44%	0.8%	0.7%
AA	0%	0.00%	1.6%	0.00%	1.6%	0.0%
A	4%	0.16%	4.0%	0.16%	4.0%	0.02%
BBB, BBB+	2%	0.08%	8.0%	0.16%	8.0%	0.2%
BBB-	1%	0.04%	8.0%	0.08%	32.0%	0.3%
BB	2%	0.08%	12.0%	0.24%	80.0%	1.6%
B & unrated	1%	0.04%	Full Ded.	1.00%	Full Ded.	1%
Totals	100%	4.00%		3.08%		3.96%

In Table 6, we show a particular RMBS transaction that, by rating standards, is a high-risk pool (with 10% subordination). The current RBC rules require 4% capital regardless of rating for prudently underwritten residential mortgage loans. The Proposal appears to reduce required capital by 25% (4 to 3%) without any change in risk exposure because it does not fully reflect the higher subordination risks of the tranches below “BBB”.

However, as Table 6 demonstrates, adjusting the risk weights to reflect a proportional relation between risk and capital reduces arbitrage possibilities substantially even when the “AAA” tranche is risk-weighted at 10% as suggested by our Comment. The sum of the required capital nearly approaches the current 4% level (3.96%) with the proposed adjustments made to the “BBB-” and “BB” tranches.⁷ While further work needs to be undertaken to determine whether our suggestion or others addresses this anomaly most efficiently for regulatory purposes, the consequence of not assigning lesser-rated and unrated securities the appropriate capital charge might be to encourage the very manipulation of risk categories that the Proposal intends to reduce.

There are other collateral effects as well: the capital advantages enjoyed by regulated institutions might distort pricing in the lower end of the “B piece” market (“BBB-” and below), since capital-advantaged institutions could afford to pay more for those “B” pieces. “Success” in this market would have the unintended effect of concentrating the riskiest securitized tranches within the bank regulatory system, or requiring some other means of regulatory or supervisory monitoring to ensure that this does not happen. Either result is undesirable, and avoidable by making certain that the capital charges on subordinate pieces in securitizations reflect their actual default risk.

GECMC Recommendation: We vigorously recommend that the Committee should refine its ratings based, risk-weighting table to provide for more favorable capital treatment for the highest rated instruments and more unfavorable capital treatment for lesser-rated and unrated instruments. We propose a 10% risk-weighting for “AAA” instruments and a reconsideration of the lesser-rated and unrated risk weightings within the context of structured transactions (with special rules be set to sufficiently “gross-up” subordinated rated and unrated tranches of structured securities or that the capital requirements for “BBB-” and lower rated securities be raised in proportion to their true relative risk of default), and would revise the Proposal accordingly.

2. The Proposal should recognize structured mortgage loan products and second liens generally as subordinate interests and assign capital accordingly.

The FFIEC has stated its general intent to eliminate capital arbitrage in structured securitization transactions in the Proposal and assign appropriate capital to holders of subordinate securitized interests. GECMC strongly supports this aspect of the Proposal. However, while we believe that the Proposal discusses the specific risk in structured loan transactions (which involve the purchase financing of a property with both a first and second

⁷ Alternatively, similar results could be achieved by “grossing up” the “BB” portion and not tranching “BBB”. Our objective here was to demonstrate that capital arbitrage opportunities could be managed by relating capital to economic risk.

lien) and second liens outside the context of securitization, we would request an explicit characterization of these obligations as recourse.⁸

The Proposal defines recourse and direct credit substitute both to include transactions in which the bank retains more than a *pro rata* risk of credit loss. Second liens generally are subordinate to the interests of the first lien holder. Thus, second liens are subject to *greater (than pro rata)* potential loss exposures in terms of loss severity than first liens because second lien holders are in the first loss position. That is, like subordinated tranches in a securitization, the second lien must be exhausted fully before the first lien holder suffers a loss.

The Proposal addresses subordinated securitized interests, requiring RBC in accordance with the risk weighting of the tranche. This is appropriate for securitized interests (subject to our qualifications stated above), where ratings are usually available and where the purchase or retention of the interest has no risk beyond those associated with the specific instrument. However, this treatment does not work effectively for unrated interests in non-securitized transactions, which in the residential mortgage business primarily means second liens. These interests should be treated as subordinate interests and combined with all senior interests to determine the required RBC.

As noted above, the second lien bears a disproportionate share of the risk of default and loss severity. Currently, particularly within the context of structured loan transactions, regulators have recognized that two loans to one person for the same purpose at the same time are one loan, and consequently require that the second lien be 100% risk weighted in recognition of the increased default risk and loss severity associated with that instrument. Separately, home equity loans also are treated similarly. However, this capital treatment still understates the risk (and corresponding capital) that the lender has retained.

We believe that the Proposal should be revised to state explicitly that the second lien loan (whether retained, purchased, part of a structured loan transaction or a separate second lien) are subordinated interests and should be treated as recourse. So, for example, a \$100,000 property with an \$80,000 first mortgage and \$10,000 second mortgage would under current regulations require a lender to hold \$800 (8% times \$10,000) of capital on the second mortgage. However, under the Proposal, the lender would have to hold \$8,000 of capital (8% times \$100,000), reflecting the first loss potential of the second lien mortgage. In that way, the FFIEC will have addressed inappropriate capital arbitrage activities by requiring its regulated entities to carry capital that reflects the risk of the second lien.

GECMC Recommendation: GECMC endorses the Proposal's more prudent RBC approach with regard to second lien loans, which would treat them as recourse obligations.

⁸ We have in mind something similar to the Proposal's treatment of spread accounts, with which we agree wholeheartedly.

3. The Proposal should apply RBC standards to credit derivatives, but clarify the RBC treatment of unrated and not traded credit derivatives, particularly those instruments with substantial market, credit, operations and measurement uncertainties associated with them.

We support the Proposal's RBC treatment for credit derivatives.⁹ However, the Proposal is unclear regarding the risk weighting of loans backed by credit derivatives. We have three concerns.

First, in terms of capital charges for credit derivatives used by a FFIEC regulated entity in a loan structuring or securitization, we support the proposed recourse treatment. Retained credit risk, whatever the instrument or structure used, is recourse and should be treated as such. Otherwise, entities subject to the final rule would not be required to acknowledge the risk retained and will be discouraged from seeking *bona fide* third party credit enhancement.

Second, the Proposal is unclear regarding how unrated, nontraded customized credit derivatives will be treated for risk weighting purposes ("portfolio insurance products", while promising, have a different set of concerns¹⁰). In terms of capital relief to the beneficiary of the credit derivative, the current practice is to treat credit default and total rate of return swaps as similar to guarantees and give the credit-enhanced asset a 20% risk weighting based on the guarantor's status as an OECD depository institution (or 50% risk weighting if not qualifying for the 20% category). The Proposal introduces the use of ratings for rated, tradable instruments and alternatively allows the use of an internal ratings system for unrated, nontraded instruments. We are unsure which risk weighting now applies – the traditional guarantor weighting, a weighting based on the external long-term financial strength or credit rating of the guarantor, or a weighting derived from application of the beneficiary's internal rating system. Together with adoption of the new 10% "AAA" risk weighting discussed above, we believe that a weighting based on the external long-term financial strength or credit rating of the guarantor is most appropriate. The "guarantor" rating does not assess counterparty risk individually, and the internal ratings approach (with its uniform 100% risk weighting for "investment grade") provides no incentive to seek the highest quality counterparty.¹¹

⁹ In terms of the definition of "credit derivative," we would suggest that it include as reference assets unrated, privately held loans, leases and obligations, whether corporate or consumer, in addition to publicly traded loans or bonds. In addition, a total-rate-of return credit derivative assumes the risk of asset depreciation as well as credit risk, so perhaps the definition of "credit derivative" should be amended to reflect that additional risk.

¹⁰ "Portfolio insurance products" are instruments that transfer the risk of a selected portfolio of credit risk away from financial institutions to the capital markets. See Moody's Investors Service, "Credit Derivatives and Credit Risk Management – Special Comment," (Dec. 1999). We analyzed one such transaction, Freddie Mac's Mortgage Default Recourse Notes, in our OFHEO comments, as did the comment submitted by the Mortgage Insurance Companies of America.

¹¹ In terms of capital charges assessed on the guarantor not involving the retained risk circumstance discussed above, the charge should be equal to the RBC treatment that would have been assessed on the beneficiary if it had not agreed to the swap if the entire credit risk is assumed. For partial assumptions, we believe the charge should be related to the loss position assumed (*i.e.*, first, second, third).

Finally, to the extent that the FFIEC intends for the Proposal to be consistent with Basle Committee's ongoing efforts in the credit risk mitigation area, we counsel caution regarding encouragement of credit derivatives through reductions in risk weighting, particularly for those involving mortgage default risk. We have reviewed the Basle Committee's proposed (January 2000) standards for guarantees, and we do not believe credit derivatives can offer an unqualified "yes" to the Basle Committee's requirements that guarantees/credit derivatives have a proven ability to absorb risk, be regulated to ensure that they can continue to do so, and meet market pricing and liquidity needs, among other factors.

For example, even a relatively developed form of credit derivative, the credit default swap, has not addressed a number of issues, which may be listed briefly:

- Unlike MI, for example, which generally uses a standardized form of insurance policy for regulatory and market standardization reasons, credit derivatives have had a "master agreement" issued by the International Swaps and Derivatives Association only since July 1999, and it is unclear whether this master agreement will standardize terms and market practices. In terms of current market practices, for example, there is no generally accepted means by which credit derivatives are marked to market (unlike interest rate derivatives).
- Since credit derivatives give their purchaser an option on default, the cost of these derivatives increases as credit markets become more volatile, raising the prospect of encouraging dependence on a form of credit risk mitigation that either might become prohibitively expensive or simply unavailable in periods of market volatility.
- Credit derivatives are as yet untested during a severe economic downturn, unlike MI, and the number of lawsuits arising from the Russian debt crisis suggests that credit derivatives remain subject to certain legal uncertainties.
- Pricing also depends on the development of consistent penalties for default, particularly bankruptcy, and there is no indication of any trend toward uniformity in that regard.

Thus, in terms of the Basle Committee's current concerns (instrument risk absorption, regulation and pricing/liquidity), credit derivatives are more problematic than other forms of prospective guarantee, such as MI. We remain unsure how these concerns will be factored into the Proposal, but suggest that the concerns be addressed in this or a separate rulemaking.

GECMC Recommendation: GECMC supports the Proposal's treatment of credit derivatives for retained credit risk as recourse, but recommends that the FFIEC clarify how credit derivatives that are unrated and not traded will be treated for RBC purposes in terms of capital benefit (with a recommended approach derived from the long-term external rating of the guarantor). The FFIEC also should consider whether and how that treatment is consistent with the emerging standards proposed by the Basle Committee.