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BY HAND DELIVERY

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Attn: Docket No. 2000-15

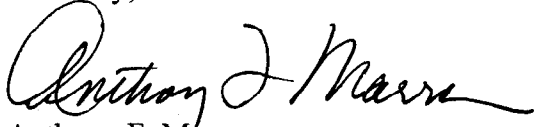
Re: Comments on Joint Interagency Proposed Regulation: "Risk-Based Capital Standards; Recourse and Direct Credit Substitutes"

Dear Sir or Madame:

Please find enclosed with this letter the comments of Fannie Mae on the joint interagency proposed regulation entitled "Risk-Based Capital Standards; Recourse and Direct Credit Substitutes."

We appreciate the opportunity to comment on this proposed regulation. If you have any questions on these comments or need further assistance, please contact Patricia Milon of our Legal Department at 202.752.7127.

Sincerely,


Anthony F. Marra

Enclosure

2000 JUN -8 P 4: 18
DISSEMINATION



June 7, 2000

Comments on Banking Agencies' Joint Notice of Proposed Rulemaking: "Risk-Based Capital Standards; Recourse and Direct Credit Substitutes"

Introduction

Fannie Mae appreciates the opportunity to respond to the March 8, 2000 proposed interagency regulation, "Risk-Based Capital Standards; Recourse and Direct Credit Substitutes" for banks, bank holding companies, and thrifts (collectively referred to as "banking organizations" in the proposed regulation). We appreciate all the work the Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (collectively referred to as the "agencies" in the proposed regulation) have done to move forward on the issue of equalizing the capital requirements for letters of credit, recourse obligations, and securitization structures with similar levels of risk, based on the principle of equal capital for equal credit risk. We also believe that the encouragement of the appropriate use of ratings and risk measurement models is a major step forward towards maintaining a safe and sound banking industry.

Our main comments are summarized as follows:

- We agree with the agencies on differentiating capital requirements based on the level of credit risk associated with asset backed transactions. However, we **strongly believe that applying traditional ratio-based capital standards to the "face value" of mezzanine risk positions will not have the intended result of lowering capital requirements on safer positions and raising requirements on risky positions. To the contrary, the proposed regulation may have the opposite effect.** We believe the proposal has flaws which undermine the proposal's effectiveness in achieving the agencies' safety and soundness objectives:
 1. The principle of equal capital for equal credit risk is violated, encouraging banking institutions to hold the riskier pieces of securitization structures.
 2. Arbitrage opportunities are created for banks since capital levels are not tied to the capital requirements for on-balance sheet assets.
 3. "Face value" approaches are inherently inconsistent with how capital requirements are determined for other financial entities including monoline insurance companies and government sponsored enterprises (GSEs). For these entities, capital requirements are tied to the economic risk of the underlying collateral and not the face value of any individual position.

4. Face value treatment is also inconsistent with the prudent movement towards internal models. Properly constructed, internal models should *always* be based on the underlying economic risk of the collateral.

Given these significant issues, we recommend that the agencies change the capital requirements for mezzanine positions to reflect more effectively the true economic risk of the underlying collateral. A more effective approach would establish the capital requirement by applying a risk weight to the mezzanine position plus all senior positions, referred to in the proposed regulation as “gross-up” treatment. Such an approach would more directly relate capital to the risk of the collateral rather than the face value of a position. If the agencies adopt a gross-up treatment to correct the serious concerns created by face value treatment, we leave it to the agencies to determine an appropriate risk-weight to apply to the grossed-up amount for each rating level. In any event, for BB-rated positions we would recommend gross-up treatment and application of a 100% risk weight, subject to the low-level recourse requirement.

Should the agencies not revise the use of face value treatment for mezzanine risk positions, then we strongly urge that the transition point between face value and gross-up treatment be moved to at least the BBB level, from the proposed BB level. Per our recommendation above, BB positions would be grossed up and placed in the 100% risk-weight category. Under the proposed regulation, we believe the level of capital that would be assigned to BB risk positions would be well below that which would be considered prudential and would create extreme regulatory capital arbitrage opportunities. We summarize later in this comment letter reasons why the agencies should be extremely cautious in relying on ratings at the BB level for asset-backed structures.

If the agencies retain face value treatment for mezzanine risk positions, at any ratings level, we would further recommend that the agencies disallow face value treatment for “very thin strip” mezzanine positions. We would regard mezzanine positions that are very small, for example, those less than 10 percent of the value of the collateral, as “very thin strip.” These positions would concentrate very substantial amounts of the risk of the collateral into a very small face value exposure, and should not be eligible for face value treatment. Such “very thin strip” positions should be required to use a gross-up treatment.

- While we believe that ratings play a valuable role, and can be used prudently in capital standards where entities lack the expertise and modeling capability to properly analyze the credit risk of exposures, there are several issues related to the use of ratings as implemented in this proposed regulation that present safety and soundness concerns:
 1. The agencies propose to allow banking organizations that receive a ratings downgrade for a position to obtain a higher rating from a different rating agency

to maintain a favorable capital treatment for a position. We oppose this provision and believe that a banking organization should maintain the use of the same rating agency over the life of the rating that was used to obtain the initial capital treatment in order to avoid ratings shopping.

In addition, the agencies have proposed that issuers obtain only one rating for traded positions, and if more than one rating is obtained, banking organizations are allowed to use the single highest rating. For structured transaction mezzanine positions (and particularly in combination with face value treatment), we believe the potential moral hazard problem presented by obtaining just one rating and allowing the banking organization to use the highest rating to obtain lower capital requirements, should be reconsidered. We also believe that it is reasonable and customary market practice to obtain two ratings, and that for many market participants (including Fannie Mae in our own credit standards), the lowest rating governs the applicable credit standard. As such, we believe the agencies should require at least two ratings for traded positions and set capital requirements on the lowest rating rather than the highest. The agencies should also consider which rating agencies are eligible to rate which asset classes, an important credit policy matter to private investors.

2. The agencies propose several ways that a banking organization can receive a favorable risk weight for non-traded positions. Since there is no arms length investor to act as a check and balance to the rating assigned to a particular risk position, there is substantial opportunity and incentive for inflated ratings through “shopping” for ratings on non-traded positions by issuers. This risk is most likely to be of concern for asset-backed transactions where each transaction may be unique and require making numerous prepayment, default and severity assumptions that have a complex priority of cash flows within the structure. Given the incentives that will exist to obtain ratings on any non-traded risk position that could benefit from the dramatically lower capital requirements enabled by the proposed regulation, we recommend the following changes for non-rated positions:
 - Reinstate the agencies’ position taken in the 1997 proposal on this topic,¹ for banking organizations that wish to use the ratings-based approach for non-traded positions, at least one other position in the structure must be traded. This requirement was intended to help ensure that there be some discipline in the ratings process through the external scrutiny brought by third party investors to a publicly traded issuance. We would add to this requirement a requirement that the traded position be transacted with a third party with which the banking organization is not affiliated. We would also add the requirement that the non-traded position be rated by the same rating agency that rated the traded position to avoid additional ratings shopping.

¹ 62 Fed. Reg. 59943 (“1997 Proposal”).

- If the agencies decide not to require any arms length validation of the ratings quality on an individual transaction basis through reinstating 1997 Proposal's traded position requirement, we would urge the agencies to establish additional oversight mechanisms for the rating of non-traded positions prior to finalizing the regulation. While the agencies have proposed that the ratings be made public, we believe that the agencies should clarify that these ratings be updated no less frequently than is customary in the public markets for traded securities.
3. The agencies have also provided for, under limited conditions, the use of internal and approved vendor models for establishing ratings. We strongly urge that, at this time, these approaches be limited to asset-backed commercial paper programs. In these programs, the agencies appear to be comfortable with the level of risk and the associated expertise and controls that have been established by some of the banking organizations. The regulation makes clear that the agencies have carefully considered these programs and clearly understand the level of oversight and review needed to grant approval for use of internal or vendor models.

For asset classes beyond asset-backed commercial paper programs, we would urge the agencies not to allow the use of internal models or vendor models. The agencies have not been able to set out, with the commensurate level of clarity, the supporting systems, procedures and controls that would be needed to assure that internal or vendor models in other asset classes are, in fact, producing results comparable to obtaining external ratings. From extensive discussions with the major rating agencies in the normal course of our business, we know that factors such as the origination and servicing practices of issuers, and the historical performance of these issuers' particular products will play a major role in the ratings assigned to mortgage-backed securities of these issuers. The richness of this analysis cannot be captured from use of just a model, although model results may be a good starting point.

If the agencies allow the use of internal and vendor models for asset classes beyond asset-backed commercial paper programs, we urge that strong standards and effective oversight criteria for the use of internal models and vendor models be published for additional public review and comment. We offer for the agencies' consideration a suggested process wherein a random sample of self-rated structures be selected by the agencies during the year and two ratings be obtained for this random sample from rating agencies with a track record of rating publicly traded transactions in the self-rated asset class. If the ratings do not match the internal ratings determined by the institution, consideration should be given to requiring the institution to obtain two ratings for all non-traded positions for the following year. The agencies may also want to consider applying this sampling process to asset-backed commercial paper programs.

4. The agencies should not approve the use of face value treatment for BB-rated positions. While we believe that face value treatment generally, and as proposed for BB risks particularly, should be rejected for mezzanine positions for reasons of capital adequacy and arbitrage, there are additional factors that we believe make it imprudent to use face value treatment for low-rated positions (especially non-investment grade positions).

Our market participation has demonstrated that there are frequently very substantial differences between ratings among rating agencies for lower-rated positions. From discussions with investors in BBB- and BB-rated tranches, independent analysis and due diligence are the overwhelming basis for their investment and pricing decisions, with the rating given very modest, if any, weight. Investors understand that ratings have different meanings between different rating agencies, and that these differences are particularly relevant for tranches that have substantial risk of loss, like BBB and BB.

Investors' independent knowledge and ability to assess risk rather than relying on ratings in the BBB and BB sector is demonstrated by the fact that we observe dramatic differences in credit spreads for lower-rated tranches of asset-backed securities across different asset-backed markets and within markets across different, but similarly rated, securities outstanding. Furthermore, the historical data support the notion that lower-rated risks, especially once a BB rating is observed, represents a statistically much greater probability of loss of capital. Therefore, we believe that the agencies, in the proposed regulation, would be placing a reliance on ratings for low-rated risks that is inconsistent with their meaning and acceptance in the private market place.

- Under the proposed regulation, banks have the incentive to obtain ratings on positions that are likely to obtain a favorable capital treatment and not obtain a rating on positions that are not likely to be favorably rated. For example, for assets where the underlying economic risk of the loans warrants a risk weight higher than the regulatory standards, banks have little incentive to get a rating since the enhancement necessary for an investment grade rating for a position is greater than the capital requirement needed to simply keep the assets on the balance sheet. Thus, the proposed regulation allows banks to arbitrage the risk-based capital requirements by choosing the most favorable treatment among several to capitalize loans with the same economic risk.
- The proposed regulation makes an attempt to align more closely regulatory capital with transactions risk. We endorse this attempt, but meaningful residual credit risk differences remain. The proposal does not differentiate for the credit risk differences between AAA and AA ratings, corporate guarantees versus structured transactions, or degrees of interest rate risk exposure. While this task is difficult, it is clear that AAA ratings are superior to AA and corporate guarantees preferred to security structures. Consequently, we recommend the agencies consider further differentiating credit risk classes to separate out the highest quality credits that enjoy a full corporate guaranty

of timely payment of principle and interest from the strongest corporate entities, notably AAA-rated firms and GSEs, for lower credit risk weights.

- While this proposed regulation does not directly deal with interest rate risk issues, we have concerns that the failure to establish adequate interest rate risk capital requirements becomes more important with the reduction in credit risk weights as set forth in the proposed regulation. We understand that the 50% risk weight currently being used for mortgages partially accounts for the substantial interest rate risk exposure inherent in the mortgage asset. We want to make the agencies aware that reducing this risk weight to 20% for AAA/AA-rated mortgage-backed securities is different than reducing the risk weight to 20% for AAA/AA-rated credit card securities, since the latter have little interest rate risk. Because the choice of risk weights seemingly is not based on a consistent methodology to identify the real economic risk of the collateral, we urge the agencies to consider differentiating risk weights based on the duration of the underlying collateral. Long duration collateral, like fixed-rate mortgages and manufactured housing, may appropriately require higher risk weights.

Further specifics on the comments summarized above are provided below. In addition, our comments on the proposed regulation with respect to implicit recourse, representations and warranties, servicing arrangements, spread accounts and environmental warranties are also provided below.

Comments on the Face Value Approach

Equal Capital for Equal Credit Risk

We agree with the agencies' approach to tiering capital requirements based on risk, and understand the appeal of using ratings as an impartial risk measure. The agencies also indicate that they created this tiering to prevent a "cliff effect" for the capital requirement between ratings levels. The cliff effect occurs when the capital requirement increases substantially between one rated position and the next lower rated position. We believe, however, that the intent to prevent a cliff effect is not reflected in the use of these risk weights for mezzanine positions in various types of structures.

Additionally, the agencies have **always** attempted to base their capital requirement on the sound premise that there should be equal capital for equal credit risk, regardless of the form in which the risk is held and that this proposal was intended to correct contrary situations in the current capital regulations. We provide below three examples that show how the equal capital for equal credit risk goal is not achieved when using the face value treatment for mezzanine positions. In addition, we demonstrate that the resulting capital requirements for mezzanine risks in asset-backed transactions are so low as to create serious safety and soundness concerns.

Example 1

Scenario 1

Assume a pool of \$1,000,000 in loans. An issuer wishes to securitize this pool of loans with no tranches. If the pool is enhanced to obtain a BB rating, the capital requirement is 200% times 8% times \$1,000,000, or \$160,000. If the issuer obtains a BBB rating on the pool, the capital requirement is reduced to \$80,000. Obtaining an A, AA, or AAA rating on the pool reduces the capital requirement even further to \$40,000, \$16,000 and \$16,000, respectively. This differentiation between the capital requirements appropriately orders the relative risks of the rated positions and is consistent with the intent of the proposed regulation.

Scenario 2

Now assume that the issuer wants to provide a credit enhancement to the \$1,000,000 in loans and tranche the security as follows: a senior \$870,000 position is rated AAA, a \$100,000 second position is rated BBB, and a \$30,000 third position is rated BB.²

The capital requirement for the AAA position would be 20% times 8% times \$870,000, or \$13,920. The capital requirement for the BBB position would be 100% times 8% times \$100,000, or \$8,000. And the capital requirement for the BB position would be 200% times 8% times \$30,000, or \$4,800. For this quite realistic example, in actual **dollar** amounts, the capital requirement for the BB position (\$4,800) is lower than for the BBB position (\$8,000), which is lower than for the AAA position (\$13,920). This result does not make sense, since the relative credit risks of the positions are in reverse to the actual dollar capital requirements.

Comparison of Scenario 1 and 2

When Scenarios 1 and 2 are compared, it shows that the “effective” capital requirement (dollar capital requirement divided by dollar value of the total collateral) for the BB position is 0.48% in Scenario 2. This is based on dividing the \$4,800 capital requirement by the underlying total collateral, which is \$1,000,000. The effective risk-weight (the risk weight that would be applied to the underlying collateral) is determined by dividing the effective capital requirement (0.48%) by 8%, which equals 6%. This 6% risk weight is 1/33th or 97% below the amount of the 200% risk weight for the BB position shown in Scenario 1-- even though the risks are similar. Therefore, the 200% risk weight, which seems like a “high” risk weight, is effectively much lower when benchmarked against the underlying collateral. The face value treatment for mezzanine positions creates a situation of very unequal capital for similar risks.

² It should be noted that Fitch Investor Services and Standard and Poor’s base their ratings on the probability of a default. Thus, a BBB thin-strip position will require the same enhancement as a BBB whole security with the same underlying collateral. Moody’s, on the other hand, bases their rating on both the probability of a default and the severity of the default (concentration risk). As a result, Moody’s requires a slightly higher enhancement level for a BBB thin-strip position relative to a BBB whole security.

The table below shows the comparison in the “effective” capital requirements and the “effective” risk weights for the rated positions in Scenarios 1 and 2. The two examples are also displayed graphically in Attachment A.

Table 1 – Comparison of Effective Capital Requirements and Risk Weights for Scenarios 1 and 2

<u>Rated Position</u>	<u>Effective Capital Requirement Percentage</u>		<u>Effective Risk Weight</u>	
	<u>Scenario 1</u>	<u>Scenario 2</u>	<u>Scenario 1</u>	<u>Scenario 2</u>
AAA/AA	1.6%	1.6%	20%	20%
BBB	8.0%	0.82%	100%	10%
BB	16.0%	0.48%	200%	6%

In the proposed regulation, the agencies state: “The proposal varies the capital requirements for positions in securitized transactions according to their relative risk exposure, using credit ratings from nationally recognized statistical rating organizations to measure the level of risk.” In fact, this objective is not achieved in Scenario 2 because of the application of a face value approach to mezzanine positions. If face value treatment is approved, the agencies will have approved lower dollar capital requirements for lower rated positions relative to higher rated positions.

If the agencies were to base the capital requirements for rated mezzanine positions on the underlying collateral, *i.e.*, the mezzanine position plus all senior positions, then the problem with lower capital requirements for BB positions relative to BBB or higher rated position can be solved.

Example 2

To illustrate how Example 1 above would work in an actual securitization structure, we show below a tranching mortgage security with jumbo loans as the underlying collateral. The security is a residential mortgage securitization issued by Washington Mutual Bank, called WAMU 2000-1. To simplify the depiction of the problem with the face value treatment, we have collapsed the AA and AAA classes into an AA class, the A and BBB classes into a BBB class, and the B and unrated classes into an unrated class (this is how S&P and Fitch would rate these collapsed classes). Table 2 shows the size of these classes, the proposed risk weight for these classes, the actual dollar capital requirement, and the “effective” risk weight based on the underlying collateral at risk.

Table 2 – Implications of the Face Value Treatment
On the Capital Requirements for a Rated Transaction

<u>Rated Position</u>	<u>Size of Position** (in Millions)</u>	<u>Percentage of Pool</u>	<u>Risk Weight</u>	<u>Dollar Capital Requirement (in Millions)</u>	<u>Effective Risk Weight</u>
AA	\$6,545	97.0%	20%	\$105	20%
BBB	\$118	1.8%	100%	\$9	1.7%
BB	\$40	0.6%	200%	\$6	1.1%

** The unrated subordinate position is \$44 million, representing 0.6% of the pool size.

As Table 2 shows, there is a major disparity between the dollar capital requirement and level of risk for the AA-, BBB-, and BB-rated positions, with the higher rated positions having the higher capital requirements and higher effective risk weights. The effective risk weights for the BB- and BBB-positions, which is based on dividing the dollar capital requirement by the underlying collateral, are 1.1% and 1.7%, respectively. These low effective risk weights were probably not the intent of the agencies when they proposed the regulation.^{3,4} Under a stressful economic environment scenario, it is quite likely that both the BB and BBB positions would suffer a complete loss.

Example 3

A third example that shows the violation of the principle of equal capital for equal credit risk occurs in the following situation. Assume that a bank tranches a mortgage-backed security into a senior piece which is 95% of the total security, a mezzanine piece that is 5% of the security, and a 0.7% enhancement that absorbs the first loss, making it the most subordinate position. Assume the mezzanine piece would receive a BB rating according to Moody's Investor Service.⁵ The effective capital requirement for the BB position is approximately⁶ the sum of 0.7% enhancement plus 0.8% (200% times 5% times 8%), or 1.5%.

If the bank sold the loans to a third party and maintained 5.7% recourse (the 5% position above plus the 0.7% enhancement), the capital requirement would be 4%. This

³ These low effective risk weight levels will vary somewhat by size of the BB and BBB tranche, but will mostly be quite a bit below the 20% risk weight level for the AA-rated senior tranche.

⁴ A similar inconsistency in capital requirements occurs for credit card securitizations where approximately a 2% enhancement is required to obtain a BB rating on a 6% tranche, which is backed up by a 9% A tranche and an 85% AAA senior tranche. The effective capital requirement on the BB tranche is 16% times 6%, or 0.96%, while the effective requirement on the senior AAA tranche is 1.6% times 85%, or 1.36%. This requirement is the reverse of the risk of the positions.

⁵ For a safe pool of jumbo loans, Moody's indicates that about 0.7% credit enhancement is necessary to obtain a BB rating on a thin-strip mezzanine position.

⁶ The 0.7% enhancement is not exactly equivalent to a 0.7% capital requirement. As prepayments and losses occur, the impact on the enhancement and the capital requirement will differ. This also does not take the capital for loss reserves into account. Thus, we have assumed that the 0.7% enhancement is approximately equal to the protection of a 0.7% capital requirement.

requirement is based on the current risk-weighting system for mortgage loans and is tied to the underlying collateral. Thus, for the same economic risk, by obtaining a 0.7% enhancement, the bank has reduced its capital requirement from 4% to 1.5%. The face value treatment gives banking organizations a large incentive to purchase or guaranty thin mezzanine positions.

Creation of Major Arbitrage Opportunities for Banks

The face value approach has the potential of creating major arbitrage opportunities for banking organizations. Banking organizations would create securitization structures with thin-strip mezzanine positions, and sell the safer higher-rated senior positions of the structure because they could obtain a very low capital requirement on the thin-strip positions.

For example, assume that a bank can purchase \$1,000,000 in mortgage loans or provide a letter of credit on a mezzanine structure in the securitization. If the institution keeps the loans on the balance sheet, the capital requirement would be \$40,000. It can also provide a letter of credit to the most subordinate \$50,000 position, which would obtain a BB rating with a \$7,000 enhancement (assume the bank puts up \$7,000 in cash for this enhancement). The effective capital requirement for the bank issuing the letter of credit would be about \$7,000⁷ plus \$8,000,⁸ or \$15,000. If the bank provided three BB-rated letters of credit, the capital requirement would be \$45,000. Across these transactions, for essentially the same amount of capital, the bank will have about three times the economic risk relative to holding the mortgage loans on the balance sheet. Banks would have a large incentive to provide letters of credit (or hold recourse) to arbitrage the capital requirements on mortgages.

This type of arbitrage has already been demonstrated in the banking industry, where banks have moved commercial paper loans off the balance sheet into asset-backed commercial paper securitizations. In effect, banks reduced their capital requirement from 8% of the on-balance sheet asset to about one-tenth that amount. This was done by moving the assets off the balance sheet and providing a letter of credit on the 10% subordinate position of the commercial loan structure. Since letters of credit already are applied against the face value of the position they cover, the capital requirement is 10% of the on-balance sheet asset amount.

The proposed regulation also creates incentives for banking organizations to obtain ratings on positions that are likely to obtain a favorable capital treatment and not obtain a rating on positions that are not likely to be favorably rated. For assets where the underlying economic risk of a loan warrants a risk weight higher than the regulatory standards, banks have little incentive to get a rating since the enhancement necessary for an investment grade rating for a position is greater than the capital requirement needed to keep the assets on the balance sheet. The proposed rule allows banks to arbitrage the

⁷ See footnote 6.

⁸ The \$8,000 capital requirement is based on multiplying the \$50,000 face value of the BB position by the 16% capital requirement for the position.

risk-based capital requirements by choosing the most favorable treatment among several to capitalize loans with the same economic risk. There may be significant adverse selection of loans to be rated, since the worse than average assets on the bank balance sheet would not be rated and these assets will still have the “average” 8% capital requirement.

In summary, the face value approach to setting capital requirements will result in much lower capital requirements for the riskier mezzanine positions, providing large incentives for banking organizations to hold or enhance mezzanine subordinate positions and sell off the safer senior positions. In all likelihood, securitization structures will be reengineered to ensure that the maximum amount of effective credit risk is concentrated into the smallest possible pieces to take advantage of what will be the face value risk capital rules of banking organizations. This is precisely the kind of regulatory arbitrage that the proposed regulation is intended to correct. We believe that, in the mortgage market, those guidelines will create regulatory capital arbitrages that the agencies will seek to correct at some future date.

Inconsistency Between the Face Value Capital Approach and the Capital Approach for Other Financial Entities and Prudent Internal Models

The agencies are proposing to establish capital requirements that are fundamentally inconsistent with the way capital requirements are set for several financial entities. In addition, the approach differs from the agencies’ long-term intent to allow the use of internal bank models. For monoline insurance companies, the capital requirements are essentially set by the rating agencies and are based on the underlying collateral of the structure being insured by the monoline insurance company, not the size (face value) of the position. For example, if a monoline insurance company provides a guaranty on a thin-strip mezzanine position in a structure, the capital requirement is based on the value of this thin-strip position plus the senior positions in the structure, i.e., the position is grossed-up, then multiplied by a factor set by the rating agencies.

For Fannie Mae and Freddie Mac, the capital requirements for mortgage assets are based on the economic risk of the underlying assets. Thus, when Fannie Mae provides a guaranty on a subordinate mezzanine position of a structure, the capital requirement is based on the economic risk of the collateral and the structure of the subordination. That is, the capital requirement for Fannie Mae is effectively based on the position being guaranteed plus all senior positions, i.e., the position is grossed up.

Finally, the agencies have indicated that the proposed regulation will allow banking organizations with an acceptable internal credit risk model to effectively establish their own capital standards. We applaud this proposal for banks that have more refined internal credit allocation models than the ratings agencies. Banks with sound internal models currently base their risk capital allocation scheme on the underlying economic risk of the position as opposed to the “face value” of the position. Thus, if a bank owns a mezzanine position in a securitization structure, its internal capital allocation scheme is effectively based on the risk of the position plus all senior positions.

In summary, the monoline credit insurers, Fannie Mae and Freddie Mac, and sound bank internal models, all base their risk-based capital requirements on the underlying risks of the assets. For a mezzanine position in a securitization structure, the capital requirement is effectively based on the risk exposure created by the face value of the mezzanine position **plus** all the positions senior to the mezzanine position.

In addition, when other major financial institutions base their capital requirements on the economic risks related to the underlying collateral for mezzanine positions in a structure, the use of the face value treatment for banking organizations will lead towards arbitraging risk in the financial services area.

Recommendation for Face Value Treatment

In the proposed regulation, the agencies provide no economic justification as to why the face value of a rated security or letter of credit should be used to determine its capital requirement. We believe that the agencies should base the capital requirements for rated mezzanine positions on the underlying collateral of the security, i.e., the mezzanine position plus all positions senior to the mezzanine position, and **not** the face value of the position.⁹ For BB-rated positions, we recommend that a 100% risk weight be applied to the grossed-up position, subject to the low level recourse requirement. For investment-grade positions, an appropriate risk weight, as determined by the agencies, would be applied to the grossed-up position. This would allow the agencies to more effectively meet the equal capital for equal credit risk goal of the proposed regulation. It would also be consistent with the approaches used for setting capital requirements for other financial entities and avoid major arbitrage consequences.¹⁰

If the agencies retain face value treatment for mezzanine risk positions, at any ratings level, we would further recommend that the agencies disallow face value treatment for “very thin strip” mezzanine positions. We would regard mezzanine positions that are very small, for example, those less than 10 percent of the value of the collateral, as “very thin strip.” These positions would concentrate very substantial amounts of the risk of the collateral into a very small face value exposure, and should not be eligible for face value treatment. Such “very thin strip” positions should be required to use a gross-up treatment.

Further, if the agencies choose to maintain the use of the face value treatment, we believe the agencies should provide for public comment an explanation of the economic rationale for using the face value approach to set capital requirements as opposed to an approach that is based on the economic risk of the underlying collateral.

⁹ Operationally, basing the capital requirement on the underlying collateral would not be complicated since it is already being done for recourse positions that are being grossed-up.

¹⁰ One approach the agencies might consider for setting capital requirements for mortgage-backed securities is to apply the capital standards applied to Fannie Mae and Freddie Mac to the mortgage portfolios of banking organizations with internal models that meet certain standards.

Comments on the Use of Ratings

General Comment

The banking agencies have proposed to use ratings for both rated and non-rated positions. As stated by Moody's Investors Services in their March 2000 response to the Basel Accord proposal to use ratings, **"The credit rating agency industry is subject to moral hazard. Every rating agency has a business incentive to assign higher ratings to issuers, who are free to choose among the agencies. This incentive is offset by a rating agency's need to maintain its reputation in the market with investors, who drive the issuers' demand for credit ratings. Pressure on issuers to 'shop' for the highest rating is increased by their use in regulation. Such practices could undermine the reliability of ratings over time."** We believe that the structure of the proposed regulation regarding how ratings would be obtained and utilized will add substantially to the potential for moral hazard. In addition, we believe the proposal requires additional controls and oversight if ratings are to be used to establish capital standards, especially in combination with face value treatment.

Ratings for Traded Positions

The agencies propose to allow banking organizations that receive a downgrade from a rating agency that issued the original rating on a traded position to go to another rating agency to maintain the original rating. This is a regulatory approach that should cause prudential concerns and will encourage ratings shopping. We believe that a banking organization should be required to maintain the use of the same rating agency over the life of the transaction.

In addition, the proposed regulation allows the use of the highest rating in establishing capital standards when more than one rating exists. We also urge the agencies to revise that portion of the proposed regulation. As stated by Moody's, there are pressures on issuers to shop for the highest rating. Historical results demonstrate that there are different standards imposed by the different rating agencies in determining ratings. This is evidenced in the Moody's response to the Basel Committee proposal that shows a wide disparity between Moody's and other rating agencies. The Moody's response indicates that in a 1997 study by Richard Cantor and Frank Packer for the Federal Reserve Bank of New York, Duff and Phelps Credit Ratings Company and Fitch Investors Services were found to rate higher than Moody's 50% and 59% percent of the time, respectively, and rate lower than Moody's only 11% and 6% of the time, respectively.¹¹ As such, we believe the potential moral hazard problem presented by a regulatory standard that requires only one rating and allows the use of the highest rating to obtain lower capital requirements should be reconsidered. We believe that **two** ratings should be required to obtain a reduction in the risk weight for publicly traded positions and the capital requirement should be based on the lower of the two ratings. This should not be an undue regulatory burden because obtaining two ratings is customary market practice, and

¹¹ For further information, see Richard Cantor and Frank Packer, "Differences of Opinion and Selection Bias in the Credit Rating Industry," *Journal of Banking and Finance* (1997).

for many market participants (including Fannie Mae in our own credit standards), the lowest rating governs the standard.

Ratings for Non-Traded Positions

For non-traded positions, there is no arms length investor to act as a check and balance to the issuer. In effect, the role of investor is delegated to the banking agencies. As stated by Moody's Investor Service, the lack of an arms-length transaction with an independent investor will create pressure on the rating agencies to award a higher rating for the non-traded position. Given the incentive that the proposed regulation provides to obtain ratings on non-traded risk positions that could dramatically lower capital requirements, the proposal has an important regulatory weakness.

One way for the agencies to address this concern is to reinstate the 1997 Proposal's requirement for non-traded positions that at least one position in the structure be traded. This requirement was intended to help ensure that there be some discipline in the ratings process through the external scrutiny brought by third party investors in a publicly traded position. We would add to this requirement a requirement that the traded position be transacted with a third party with which the banking organization is not affiliated. We would also add the requirement that the non-traded position be rated by the same rating agency that rated the traded position to avoid additional ratings shopping.

If the agencies decide not to require an arms length validation of the ratings quality on an individual transaction basis through reinstating the 1997 Proposal's traded position requirement, we urge the agencies to establish an effective oversight mechanism in the final regulation to ensure that the ratings for non-traded positions are appropriately established. This oversight mechanism is especially important since the agencies are targeting their proposal for non-traded positions towards the **riskier** BB and BBB rated positions.

Additionally, there are many types of direct credit substitutes that are used to provide investors with assurances that if issuers cannot make their timely payments, the direct credit substitute issuer will fulfill the obligations of the issuer. For instance, a bank will provide a letter of credit to an issuer on the subordinate position of a structure that will be sold to investors. When defaults occur, the issuer is required to make timely payments to investors. If the lender cannot make payment to investors, the bank that issued the letter of credit will step in and ensure timely payment to investors. For this type of letter of credit, the rating of the position that is guaranteed is complicated by the fact that the rating agency needs to evaluate both the creditworthiness of the position being guaranteed and the creditworthiness of the issuer. This complicated process only exacerbates the moral hazard issue related to obtaining ratings for non-traded positions.

Finally, while the agencies have proposed that the ratings be made public, we believe that the agencies should clarify that these ratings be updated no less frequently than is customary in the public markets for traded securities.

Ratings for Non-Traded Positions for Institutions with an Acceptable Internal Model, a Model Based on Specifications Set by a Rating Agency, or a Qualified Rating Software Mapped to Public Rating Standards

The agencies propose three approaches where different kinds of models can be used in lieu of obtaining two ratings for a non-traded position. These include an internal model developed by a bank, a model based on specifications set by a rating agency, and qualified rating software mapped to public rating standards. We strongly urge that, at this time, these approaches be limited to asset-backed commercial paper programs. For these programs, the agencies appear to be comfortable with the level of risk and the associated expertise and controls that have been established by some of the banking organizations. The agencies have also established several criteria that will be used as an oversight mechanism for these programs.

For asset classes beyond asset-backed commercial paper programs, we urge the agencies not to allow the use of internal models or vendor models. The agencies have not been able to set out, with the commensurate level of clarity, the supporting systems, procedures and controls that would be needed to assure that internal or vendor models in other asset classes are, in fact, producing results comparable to external ratings. From extensive discussions with the major rating agencies in the normal course of our business, we know that factors such as the origination and servicing practices of issuers, and the historical performance of these issuers' particular products will play a major role in the ratings assigned to the mortgage-backed securities of these issuers. The richness of this analysis cannot be captured from use of just a model, although model results may be a good starting point.

If the agencies allow the use of internal and vendor models for asset classes beyond asset-backed commercial paper programs, we urge that strong standards and effective oversight criteria for the use of internal models and vendor models be published for additional public review and comment. One type of oversight mechanism would be a process wherein a random sample of self-rated structures is selected by the agencies during the year and two ratings are obtained for this random sample from rating agencies with a track record of rating publicly traded transactions in the self-rated asset class. If the ratings do not match the internal ratings determined by the institution, consideration should be given to requiring the institution to obtain two ratings for all non-traded positions for the following year. The advantage of this approach is that it achieves the goal of lowering the costs of obtaining a rating for every transaction and helps in the oversight of the various types of models. The agencies may also want to consider applying this sampling process to asset-backed commercial paper programs.

Transition Point Issues

While we have recommended a "gross-up" treatment for all mezzanine risk positions in this proposed regulation (with 100% risk weight applied to grossed-up BB-rated positions and risk weights applied to the grossed-up investment grade positions as determined by

the agencies), we understand that for the final regulation, the agencies may wish to combine the face value treatment for some positions with the gross-up treatment for others. As proposed, this transition point occurs at risk positions rated below BB. We believe the agencies should change this “transition” point between face value and gross-up treatment for asset-backed exposures to risk positions rated below BBB. A BB transition point places reliance on the consistency and quality of ratings which knowledgeable market participants do not. In addition, the available data shows a large difference in the credit risk for BB and BBB-ratings. Consider the following:

- In our experience, while there may be a reasonable alignment between rating agencies on the enhancements needed to achieve high ratings (like AA or AAA), there can be dramatic differences between rating agencies at the lower ratings. This is to be expected, since rating agencies rate many asset classes for which historical experience (including experience during an economic downturn) is very limited. Therefore, determining very safe levels of enhancement (AA, AAA) is likely to be much more reliable than predicting where lower levels of enhancement (A, BBB, BB) should be set.
- In many asset-backed markets, positions rated BBB or lower may not trade or may be very infrequently traded. Buyers are very limited, and those that do buy, may ignore or place very limited reliance on ratings. They do extensive individual due diligence and their differences in views from those at the rating agencies regarding risk can be seen by the widely differing credit spreads observable in the market for similarly rated tranches of different asset-backed security classes (and similarly rated tranches of different securitizations in the same asset class).
- The same rating means different economic risk, by definition, depending on the rating agency analyzing an asset-backed security tranche. Some ratings represent only the probability of suffering a loss (incidence) while others represent both the probability and severity of loss. These distinctions can be extremely material in highly leveraged mezzanine positions in asset-backed transactions.
- Evidence exists showing there is a large relative difference in the credit risk of a sub-investment grade position and investment grade positions. Attachment B presents a table of one-year default rates for corporate bond issuers over the period 1970-98.¹² This table presents 29 individual cohort years, the average (“mean”) one-year default experience, the standard deviation of defaults, and the maximum (“MAX”) default rate for each rating across all origination years. This latter value provides the worst experience for each rating independent of origination year. For example, the MAX default rate value for A is 0.26% from the 1982 cohort, the MAX value for BBB is 1.33% from the 1986 cohort, and the MAX value for BB is 5.25% from the 1991 cohort.

¹² See Moody’s Special Comment, “Historical Default Rates of Corporate Bond Issuers, 1920-1998,” *January, 1999*.

The Moody's data and associated statistics clearly depict risk that is significantly greater for sub-investment grade than investment grade. Specifically, the average default experience for a BB-rated entity is over 8 times that of a BBB entity and the MAX experience is about 4 times that of BBB. Because the proposed regulation only increases the capital requirement by a factor of two for a BB-rated position versus a BBB-rated position, when risk is increasing substantially more than that, the residual exposure must be borne by the banking system. The combination of face value treatment and inappropriate risk-weights for sub-investment grade enhancements results in undercapitalization and excessive risk-taking.

Recommendations on Traded and Non-traded Positions

For traded positions, we recommend the following:

- The agencies have proposed to allow banking organizations that receive a ratings downgrade for a position to obtain a higher rating from another rating agency to maintain a favorable capital treatment for a position. We oppose this proposal and believe that a banking organization should be required to maintain the use of the same rating agency over the life of the rating that it used to get the initial favorable capital treatment.
- The agencies have proposed to allow banking organizations to obtain one rating for a traded position to receive a favorable risk weight for the position. As proposed, banking organizations would also be allowed to use the highest of the ratings when two or more ratings exist. We recommend that the agencies revisit the proposed regulation to require banking organizations to obtain two ratings for traded positions and set capital levels based on the lower of the two ratings.

For non-traded positions, we recommend the following:

- The agencies should reinstate the 1997 Proposal's requirement for non-traded positions that at least one position in the securitization structure be traded. This requirement was intended to help ensure that there be some discipline in the ratings process through the external scrutiny brought by third party investors in a publicly traded position. We would add to this requirement a requirement that the traded position be transacted with a third party with which the banking organization is not affiliated. We would also add the requirement that the non-traded position be rated by the same rating agency that rated the traded position to avoid additional ratings shopping.

If the agencies decide not to reinstate the 1997 Proposal's requirement that one position be traded, they should establish additional oversight mechanisms for non-traded positions in the final regulation. While the agencies have proposed that the ratings be made public, we believe that the agencies should clarify that these ratings

be updated no less frequently than is customary in the public markets for traded securities.

- The agencies should not allow the use of internal models and approved vendor models beyond asset-backed commercial paper programs, until they set out, with appropriate clarity, the supporting systems, procedures and controls needed to assure that these models produce results comparable to external ratings. If the agencies allow the use of internal and vendor models for asset classes beyond asset-backed commercial paper programs, we urge that strong standards and effective oversight criteria be published for additional public review and comment.
- While we believe the agencies should gross up all mezzanine risk positions and apply an appropriate risk-weight to the grossed-up position, if the agencies decide to maintain the face value treatment, we believe they should use the BBB-rated position as the transition point between gross-up and face value treatment, instead of the BB-rated position (i.e., a 100% risk weight should be applied to the grossed-up BB-rated position). Our market participation has shown that there are frequently very substantial differences between ratings among rating agencies for lower-rated positions.
- Additionally, for “very thin strip” investment grade mezzanine positions, we believe that there should be a minimum size for the position to partially avoid extra capital arbitrage opportunities. We have recommended that the size of the position should be no smaller than 10 percent of the underlying collateral to qualify for face value treatment.

Further Considerations

The proposal makes an attempt to align more closely regulatory capital with transactions risk. We endorse this attempt, but meaningful residual credit risk differences remain. The proposal does not differentiate for the credit risk differences between AAA and AA ratings, corporate guarantees versus structure transactions, or degrees of interest rate risk exposure. While this task is difficult, it is clear that AAA ratings are superior to AA and corporate guarantees preferred to security structures. Consequently, we recommend the agencies consider further differentiating credit risk classes to separate out the highest quality credits that enjoy a full corporate guaranty of timely payment of principle and interest from the strongest corporate entities, notably AAA-rated firms and GSEs, for lower credit risk weights.

For example, the value of a full corporate guaranty combined with an asset backed security can most clearly be seen from the perspective of one large corporation that has the alternative of reorganizing into a single parent company that owns multiple sole purpose subsidiaries. As a single entity that issues debt to finance its assets, its corporate debt obligations are effectively cross-collateralized by the equity in the firm. If this firm reorganizes with multiple SPVs and each issues its own debt, it has eliminated the cross-collateralization and has made the failure of any single subsidiary more likely than when it

was issuing a single corporate guarantee. The net effect is that the corporate guarantee should be worth more than the rating on a structured security, even if the assets underlying both are identical.

Comments on Implicit Recourse, Representations and Warranties, Servicer Arrangements, Spread Accounts and Environmental Warranties

Implicit Recourse

As with the 1997 Proposal, the proposed regulation notes that the decision as to whether an action of a banking organization constitutes “implicit recourse” will be case by case and fact-dependent. Examples include: (a) providing voluntary support for a securitization by selling assets to a trust at a discount from book value; (b) exchanging performing for non-performing assets; or (c) other actions that result in significant transfer of value in response to deterioration in the credit quality of a securitized asset pool. The proposed regulation seeks comment on how to make this treatment of implicit recourse workable.

We recommend that the proposal clarify that implicit recourse will not be found in purchase transactions in which the seller must repurchase the loan as a remedy for breach of an operational warranty. The result should be the same if some lesser remedy for breach of warranty is imposed, such as indemnifying the purchaser against loss, if any. We believe that this is the result intended by the agencies.

Representations and Warranties

The 1997 Proposal treated as recourse or a direct credit substitute any representation or warranty other than a “standard” representation or warranty. The proposed regulation focuses on whether a warranty allocates credit risk to the banking organization, rather than on whether the warranty is somehow standard or customary within the industry. The proposed regulation cites as support for this new focus an awareness that “warranties sometimes characterized as 'standard' ...effectively function as credit enhancements. These include warranties that transferred loans will remain of investment quality, or that no circumstances exist involving the loan collateral or the borrower's credit standing that could cause the loan to become delinquent. They may also include warranties that, for seasoned mortgages, the value of the loan collateral still equals the appraised value and the borrower's ability to pay has not changed adversely.”

The proposed regulation recognizes that banking organizations also make factual warranties unrelated to ongoing performance or credit quality. These warranties entail “operational risk” as opposed to the open-ended credit risk inherent in a financial guaranty. Warranties that create operational risk include: warranties that assets have been underwritten or collateral appraised in conformity with identified standards, and warranties that provide for the return of assets in instances of incomplete documentation or fraud.

Fannie Mae believes the new focus of the agencies is appropriate. However, there are at least two representations and warranties that are used widely in the industry under standard

Fannie Mae seller/servicer contracts that may be interpreted to fall into a “gray” area under the wording of the preamble to the proposed regulation. We recommend that the agencies clarify that these representations are “operational” as described below.

The preamble states that a warranty given by the seller that the transferred loans will remain of investment quality or that no circumstances exist involving the loan collateral or borrower's credit standing that could cause the loan to become delinquent should be treated as the effective equivalent of a credit enhancement. The final rule should distinguish a warranty that the seller has no knowledge of circumstances that could cause a loan to be other than investment quality or to become delinquent from a warranty that flatly states that no such circumstances exist. The former warranty involves the seller's performance of underwriting standards and thus should be considered operational. Further, if an investor cannot obtain a warranty from a seller that the seller has no knowledge of existing circumstances that could cause a loan to become delinquent, the seller has license to engage in fraud. In contrast, a broad representation that no such circumstances exist (with no qualification of personal knowledge) is similar to a guaranty of performance and, as such, appropriately may be classified as the equivalent of a credit enhancement. However, we are not suggesting that knowledge is a necessary element of an operational warranty. Sellers make scores of warranties that are factual and unrelated to ongoing performance or credit quality. These are appropriately classified as operational warranties regardless of the seller's actual knowledge because they concern matters that are subject to the seller's control and/or verification. Rather, our point is only that a warranty that would be classified as a credit enhancement because it is a broad and conclusory “blanket” warranty that encompasses future credit performance (i.e., to the effect that a loan will remain of investment quality, or that it is free of circumstances that could result in delinquency) should be treated as an operational warranty if it is narrowed to encompass only the seller's knowledge.

The proposed regulation also lists in the category of “credit enhancing warranties” those that, for seasoned mortgages, represent that the value of the loan collateral still equals the appraised value and that the borrower's ability to pay has not changed adversely. In practice, Fannie Mae typically requires the seller of a seasoned loan to warrant that the value of the property has not declined. This is an operational warranty that should not result in recourse treatment to the seller. The seller is capable of verifying an estimate of the current value of the seasoned loan being sold through a variety of operational means -- including through the use of widely available, sophisticated property databases, re-appraisal and knowledge of market conditions. Thus, this warranty is something that can be managed by the seller. We therefore recommend that the agencies clarify that a representation or warranty given by a seller as to the non-declining value of the loans sold is an operational warranty with respect to seasoned loans -- if the seller can show that appropriate due diligence has occurred.

As a separate issue, the 1997 Proposal implied, but did not clearly mandate, the non-recourse treatment of standard representations and warranties in which the investor has a contractual right to rely on such representations and warranties for an indefinite period. This appeared to be the intent, assuming that the original warranties related to issues that the seller could either control or verify with reasonable due diligence at the time the assets were

sold or the servicing rights are transferred. The proposed regulation does not expressly state this result. The final rule should clearly endorse such a right of indefinite reliance on “operational” warranties as not constituting “recourse” obligations.

In previous negotiations in which sellers have requested that Fannie Mae put a time limit on representations and warranties, Fannie Mae consistently has refused to do so despite the risk of lost business. It continues to be our conviction that such time limits are not prudent and would prejudice the efficient operation of a wholesale secondary market for residential mortgages.

Loan Servicing Arrangements

The proposed regulation states that the definitions of “recourse” and “direct credit substitute” cover loan servicing arrangements if the servicer is responsible for credit losses on the loans being serviced. A residential mortgage servicer's obligation to make cash advances to ensure an uninterrupted flow of payments to investors or the timely collection of the mortgage loans is specifically excluded from the definitions of “recourse” and “direct credit substitute,” provided that such servicer is entitled to reimbursement for its “significant advances.” The proposed regulation further states that if a servicer is not entitled to full reimbursement, the maximum amount of any nonreimbursed advances on any one loan must be contractually limited to an “insignificant amount” of the outstanding principal in order for the obligation to make cash advances to be excluded from the definitions of recourse and direct credit substitute. Under the proposal, nonreimbursed advances on any one loan that are contractually limited to no more than one percent of the amount of the outstanding principal on that loan would be considered “insignificant.”

Fannie Mae supports the agencies’ approach with respect to loan servicing arrangements. For example, Fannie Mae servicers often are obligated to advance delinquent principal and interest -- but, because Fannie Mae reimburses its servicers for these advances in all events,¹³ that obligation should not be treated as a credit enhancement that would trigger recourse treatment for the servicer.

However, the proposed regulation requires clarification to achieve the presumably intended result with respect to some types of cash advances made by servicers. In the Fannie Mae Servicing Guide, such advances -- other than those made for principal and interest -- are termed “servicing advances.” Upon completion of foreclosure, if the seller/servicer has properly conducted its contract obligations, Fannie Mae is contractually obligated to provide full reimbursement for servicing advances that are actual, reasonable, and appropriately documented by a timely request.¹⁴ If a servicer fails to carry out servicing responsibilities for delinquent loans as contemplated by the contract, the expenses of handling a delinquent loan may substantially exceed the expenses that would otherwise result. In such cases, Fannie Mae may not provide “full reimbursement” of such expenses (for example, legal fees) insofar as they are excessive because of the servicer's contractual violations. This

¹³ See Fannie Mae Servicing Guide, Part I, Section 202.02, and Part X, Section 302.

¹⁴ See Fannie Mae Servicing Guide, Part VIII, Section 107 and Part I-202-03.

arrangement incents servicers to perform efficiently, and recognizes that the servicer alone controls the use of its own diligence and resources to comply with contract requirements designed to avert undue delay. Further, reimbursement is conditioned on a timely request with appropriate documentation showing that the expenses were actual, reasonable, and necessary.

To provide clarification that this approach is in fact intended by the proposed regulation, Fannie Mae suggests that the agencies provide a simple clarification that a servicer's obligation to make cash advances is not a recourse obligation or a direct credit substitute if the mortgage servicer is entitled to full reimbursement, subject only to the servicer's compliance with its contractual obligations to the noteholder and the requirement that requests for reimbursement be timely made with appropriate documentation showing expenses that are actual, reasonable, and necessary.

Spread Accounts and Overcollateralization

The preamble to the proposed regulation clarifies that overcollateralization normally does not fall within the proposed definition of recourse because it normally does not impose a risk of loss on the banking organization that has sold the related loans. The preamble also provides that use of a spread account has the same result, unless the banking organization retains an interest in the spread account that is reflected on its balance sheet either as an asset or as a receivable. This is because in those cases, the banking organization bears the loss in the event that the related loans it has sold do not perform.

It would be helpful to clarify that the result is the same for any credit enhancement that is generated from the loans sold, provided that the seller is not at risk for nonperformance of the loans. Further, it would be helpful to extend this discussion to clarify that a banking organization will not be treated as having recourse if it purchases a credit enhancement from a third party that protects the purchaser from credit loss (for example, a mortgage insurance pool policy) such that the banking organization cannot be required to bear any portion of the loss caused by nonperformance of the loans it sells. This result should be the same whether the banking organization pays for the third-party credit enhancement in a single payment concurrently with sale of the loans, or is obligated to make periodic payments without regard to performance of the loans. In the latter case, the banking organization's liability is for the amount of the agreed-upon payments when due, not for nonperformance of the loans it has sold.

Environmental Warranties

The proposed regulation indicates that examiners will likely make case-by-case decisions on which environmental warranties create recourse. It states that:

A warranty that asset collateral is free of environmental hazards *may* present acceptable operational risk for certain types of properties that have been subject to environmental assessment, *depending on the circumstances*. The agencies address appropriate limits for these operational risks through supervision of a banking

organization's loan underwriting, sale, and servicing practices. Also, a banking organization that provides warranties to loan purchasers and investors must include associated operational risks in its risk management of exposures arising from loan sale or securitization-related activities. Banking organizations should be prepared to demonstrate to examiners that the operational risks are effectively managed.”

In the 1997 Proposal, the agencies took a similar position, finding that it would constitute recourse for a lender to warrant unconditionally that “all properties underlying a pool of transferred mortgages are free of environmental hazards,” because it would not be able to absolutely verify that a property is, in fact, free of all environmental hazards.

Fannie Mae offers customers engaging in certain multifamily transactions the option of providing two warranties regarding environmental hazards. Under the first option, the lender conducts industry-standard assessments and warrants that the studies revealed no environmental hazards that would render the property unacceptable for purchase. The second option is a warranty that the property is not in violation of federal or local law relating to environmental conditions both on the delivery date of the loan and in the future. Lenders who sell us seasoned loans in many cases originated the loans before the availability of standard environmental assessment methods. They frequently choose the second alternative, to avoid the added costs of an environmental assessment. However, the second option arguably places the lender at risk of repurchase based on a warranty of facts not verifiable by it, and could therefore be deemed to create recourse under the proposed regulation.

Liability for unknown environmental hazards has not been viewed by the seller as a significant risk in selling loans that the seller originated not with the intention to securitize but with the intention to hold in portfolio. Because these loans have been in the seller's portfolio for a period of time, the seller has a degree of confidence based on its underwriting and prior experience with the loan. As a result, sellers have been very comfortable giving this warranty based on their assessment that the likelihood of the existence of an unknown environmental hazard is minuscule.

Also, experience has shown that it is not cost effective for the seller to do environmental assessments on portfolio loans at the time of sale in order to be able to provide the warranty under the first option (which assumes the seller will incur the cost of performing industry-standard assessments). If this rule is adopted as proposed, sellers will incur additional costs in selling seasoned loans from their portfolio because they will either need to increase their capital or incur the cost of obtaining environmental assessment reports. This would put sellers subject to this rule at a competitive disadvantage to other multifamily lenders. However, the seller is merely assuming normal operational risk and under these circumstances, the second warranty option should not be considered recourse or a direct credit substitute.

A similar competitive disadvantage would occur in another category of transactions in which sellers opt to use the second warranty option, when they sell Fannie Mae “small

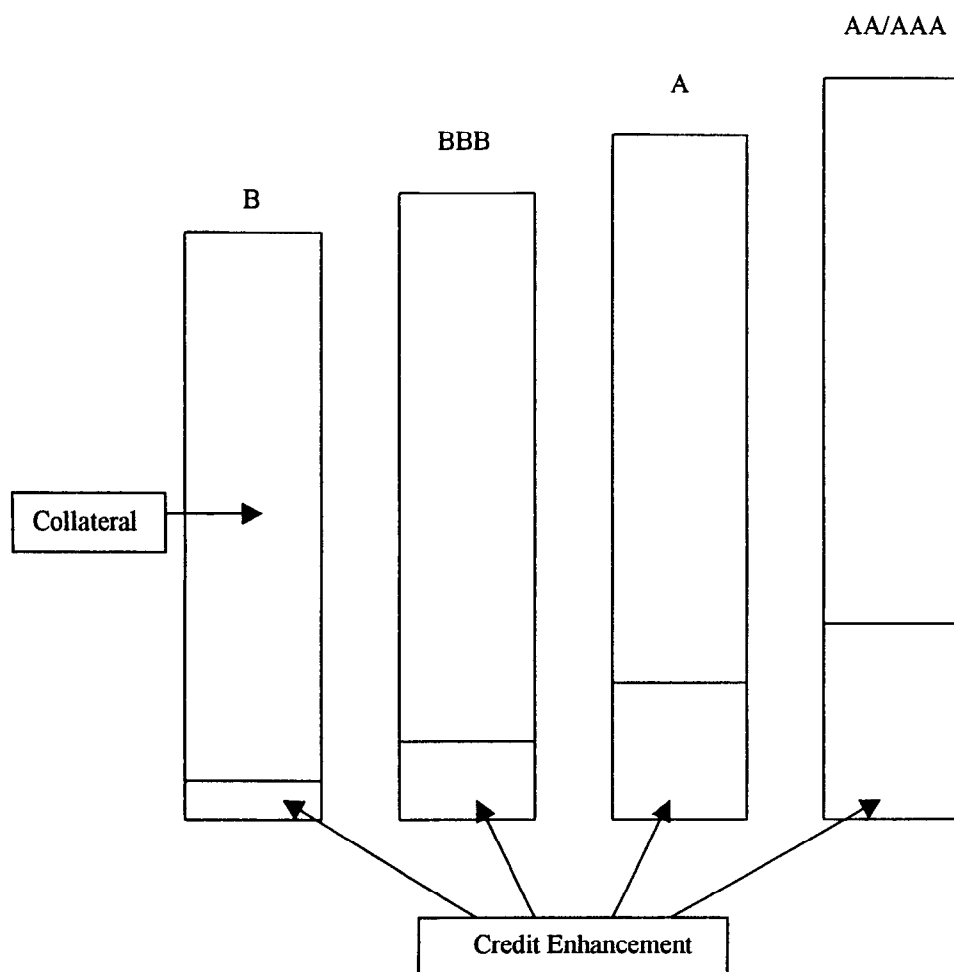
multifamily loans” (defined as loans that are either less than or equal to \$3 million or secured by multifamily properties containing 5 to 50 residential units). With a small loan, the seller may have engaged in environmental due diligence without obtaining an industry standard assessment report and therefore the seller is unable to give Fannie Mae the first warranty. In those instances, the seller is required to give us the second warranty. If the proposed regulation is adopted, bank and thrift sellers of these small multifamily loans either would need to increase their capital requirement or incur the cost of obtaining industry standard assessment reports.

To avoid these adverse capital results, we recommend revising the proposed regulation to treat as a non-recourse warranty an undertaking that the property is not in violation of federal or local law relating to environmental conditions both on the delivery date of the loan and in the future, if either given with respect to a loan (i) that the seller originated with the intention to hold in portfolio, or (ii) that is a small multifamily loan as defined above, for which the seller has performed environmental due diligence.

Attachment A

Examples Depicting the Problem with the Face Value Approach for Mezzanine Positions

Example 1: Application of Face Value Treatment to \$1,000,000 of Loans that are Securitized and Credit Enhanced to Various Ratings Levels

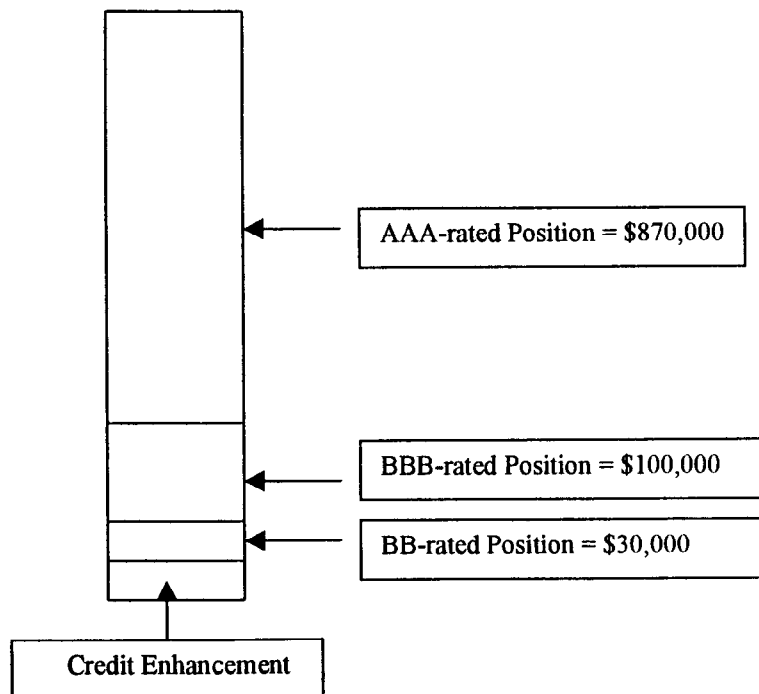


<u>Rating</u>	<u>Proposed Risk Weight</u>	<u>Dollar Amount of Face Value</u>	<u>Dollar Amount of Capital Req.</u>
BB	200%	\$1,000,000	\$160,000
BBB	100%	\$1,000,000	\$80,000
A	50%	\$1,000,000	\$40,000
AA/AAA	20%	\$1,000,000	\$16,000

As the above numbers show, the actual dollar requirements for the above rated positions are ordered based on the relative level of risk of the position. That is, the BB rated position has a higher capital requirement than BBB which has a higher requirement than A, etc.

**Continuation of Examples Depicting the Problem with
the Face Value Approach for Mezzanine Positions**

**Example 2: Application of Face Value Treatment to a \$1,000,000
Security that is Tranched into Various Ratings Levels**



<u>Rating</u>	<u>Proposed Risk Weight</u>	<u>Dollar Amount of Face Value</u>	<u>Dollar Amount of Capital Req.</u>	<u>Effective Risk Weight on Position as a % of Underlying Collateral</u>
BB	200%	\$30,000	\$4,800	6%
BBB	100%	\$100,000	\$8,000	10%
AA/AAA	20%	\$870,000	\$13,920	20%

As the above numbers show, the riskiest position, the BB position, has a capital requirement that is \$3,200 lower than the next riskiest position, which is the BBB position. The BBB position, which is the second riskiest position has a capital requirement that is \$5,920 lower than the safest position in the securitization structure, the AAA position.

The reason for this is that the face value treatment results in an effective risk-weight on the underlying collateral (as defined as the position in question plus all senior positions) that is significantly lower than the risk weight proposed for the face value of the position. Thus, even though the 200% risk weight seems like it would be a high risk weight for the BB position, the effective risk weight is actually 1/33 of the 200% risk weight, or 6% (the effective capital requirement for the BB position is 0.48%). By using the face value treatment there is a 97% reduction in the capital requirement for a BB position

As Examples 1 and 2 show, there is a problem with the use of the face value treatment for mezzanine positions. It results in capital requirements for the position that do not make sense and is not based on the economic risk of the position. Any capital system that is developed by the regulators should base the capital requirements for a mezzanine position on the underlying collateral, i.e., apply a risk weight to the sum of the mezzanine position plus all senior positions.

Attachment B

MOODY'S BOND RATINGS ONE-YEAR DEFAULT RATES

Year	Rating					
	AAA	AA	A	BBB	BB	B
1970	0.00	0.00	0.00	0.27	4.12	23.38
1971	0.00	0.00	0.00	0.00	0.42	4.00
1972	0.00	0.00	0.00	0.00	0.00	7.41
1973	0.00	0.00	0.00	0.45	0.00	3.92
1974	0.00	0.00	0.00	0.00	0.00	10.34
1975	0.00	0.00	0.00	0.00	1.02	6.15
1976	0.00	0.00	0.00	0.00	1.01	0.00
1977	0.00	0.00	0.00	0.27	0.52	3.39
1978	0.00	0.00	0.00	0.00	1.08	5.56
1979	0.00	0.00	0.00	0.00	0.49	0.00
1980	0.00	0.00	0.00	0.00	0.00	5.06
1981	0.00	0.00	0.00	0.00	0.00	4.60
1982	0.00	0.00	0.26	0.30	2.73	2.41
1983	0.00	0.00	0.00	0.00	0.91	6.36
1984	0.00	0.00	0.00	0.36	0.83	6.78
1985	0.00	0.00	0.00	0.00	1.75	8.28
1986	0.00	0.00	0.00	1.33	2.05	11.80
1987	0.00	0.00	0.00	0.00	2.72	5.86
1988	0.00	0.00	0.00	0.00	1.24	6.02
1989	0.00	0.61	0.00	0.60	2.98	9.17
1990	0.00	0.00	0.00	0.00	3.32	16.11
1991	0.00	0.00	0.00	0.28	5.25	14.66
1992	0.00	0.00	0.00	0.00	0.30	9.00
1993	0.00	0.00	0.00	0.00	0.55	5.76
1994	0.00	0.00	0.00	0.00	0.23	3.81
1995	0.00	0.00	0.00	0.00	0.67	4.84
1996	0.00	0.00	0.00	0.00	0.00	1.45
1997	0.00	0.00	0.00	0.00	0.19	2.10
1998	0.00	0.00	0.00	0.12	0.61	4.08
mean	0.00	0.02	0.01	0.14	1.21	6.63
std	0.00	0.11	0.05	0.28	1.37	4.99
MAX	0.00	0.61	0.26	1.33	5.25	23.38

Source: Moody's Special Comment, "Historical Default Rates of Corporate Bond Issuers, 1920-1998", January 1999.