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Executive Vice President
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June 7, 2000

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
Re: Docket No. R-1055

Docket No. 00-06
Communications Division, Third Floor
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/OES
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Manager, Dissemination Branch
Records Management and Information Policy
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552
Attention Docket No. 2000-15

Re: Risk-Based Capital Standards:
Recourse and Direct Credit Substitutes

Ladies and Gentlemen:

The Chase Manhattan Corporation (Chase) welcomes the opportunity to comment on the joint proposal (the *Joint Proposal*) of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision (collectively the *Banking Agencies*) that was published at 65 Fed. Reg. 12319. The *Joint Proposal* reiterates and refines many of the points that were made in an earlier joint proposal on the same subject. 62 Fed. Reg. 59944 (the *1997 Proposal*). The *Joint Proposal* would amend the risk-based capital guidelines (the *Guidelines*) of each of the Banking Agencies generally to treat direct credit substitutes and retained recourse in a like manner. Moreover, the *Joint Proposal* would provide greater differentiation in the risk-based capital requirements applicable to the different *tranches* in certain asset securitizations.

As stated in its comments to the *1997 Proposal*, Chase strongly supports the goal of making capital requirements more closely reflect relative exposure to credit risk. Chase applauds the introduction of greater differentiation between levels of credit risk when determining risk-based capital requirements. However, the use of credit quality to achieve greater differentiation should not be limited to asset securitizations, but should apply to bank loan portfolios in general. In this regard, Chase notes that last June the Basel Committee on Banking Supervision (the Basel Committee) issued a consultative paper entitled *A New Capital Adequacy Framework* (the *Proposed Framework.*) The *Proposed Framework* would introduce greater differentiation in required capital charges for bank portfolios generally.

Chase has a number of concerns about the *Joint Proposal*. It also wishes to offer a number of recommendations on how the *Joint Proposal* should be improved.

I. Summary of the *Joint Proposal*

Subject to the low-level recourse rule, the *Guidelines*, as currently set forth, require a banking organization that transfers assets while retaining any recourse to maintain capital against the entire amount of the assets transferred. However, a banking organization that provides a letter of credit or other credit enhancement (a *direct credit substitute*) in connection with the transfer of assets by a third party need only maintain capital against the amount of the direct credit substitute. In general, the *Joint Proposal* would extend the capital treatment applicable to asset transfers with recourse to those direct credit substitutes that provide credit enhancement to senior positions.

In certain asset securitizations, the *Joint Proposal* would adopt a multi-level approach to assessing capital requirements. Primarily, the *Joint Proposal* would use credit ratings from nationally recognized securities rating organizations (*rating agencies*) to measure relative exposure to credit risk and to determine the associated risk-based capital requirements (*ratings-based approach*).

For certain unrated *direct credit substitutes*, the *Joint Proposal* would allow alternative approaches for determining the risk-based capital requirements. Of these alternatives, the most

salient would permit the limited use of an institution's internal risk-rating system. Unfortunately, the lowest risk-weight allowed to be ascribed under such an internal rating system would be 100%.

II. Comments by Chase:

A. Equating *Direct Credit Substitutes* with *Retained Recourse*:

Like the *1997 Proposal*, the *Joint Proposal* would essentially treat *direct credit substitutes* that provide credit enhancement to more senior positions in asset securitizations in the same manner as *retained recourse*. However, the rationale supporting such treatment rests on an oversimplification. The concept that a bank that issues a *direct credit substitute* should be treated like a bank that *retains recourse* is based on the fact that both banks share an analogous level of seniority. Both a *direct credit substitute* and *retained recourse* are subordinate to, and therefore, supportive of more senior positions.

The subordinate position of an extension of credit should be considered when evaluating the credit risk entailed. However, that factor should not be the sole measure of credit risk or the sole determinant for a geometric increase in the applicable capital requirement.

Direct credit substitutes and retained recourse arrangements do not expose a banking organization to equivalent credit risk. In a securitization, a *direct credit substitute* is an extension of credit provided by an independent organization in accordance with its normal credit standards. As such, a *direct credit substitute* is not different in principle from extensions of credit generally. On the other hand, the *retention of recourse* in an asset transfer does not involve the independent evaluation by any third party and need not satisfy any credit standards. Moreover, unlike a bank that retains recourse, or even one that extends an ordinary loan, the issuer of a *direct credit substitute* is rarely in a *first-loss* position. Accordingly, although a *direct credit substitute* may appear to be structurally similar to the *retention of recourse*, a *direct credit substitute* is qualitatively more like ordinary lending transactions. In this regard, Chase pointed out in its comments on the *1997 Proposal* there is no empirical evidence showing that third-party credit enhancements in asset securitizations have entailed greater risks than bank assets generally.

In the absence of some type of amelioration, equating *direct credit substitutes* with *retained recourse* would impose extraordinarily Draconian capital requirements on *direct credit substitutes*. To some extent, the need to mitigate such consequences made it necessary to develop the *ratings-based approach* and alternative approaches to determine more realistic risk-based capital requirements.

Indeed, there is language in the preamble to the *Joint Proposal*, itself, that calls into question the proposition that *direct credit substitutes* and *retained recourse* should be treated as equivalents for risk-based capital purposes:

> Limiting the [internal risk ratings] approach to these types of credit enhancements [unrated direct credit substitutes in asset-backed commercial paper programs] reflects the [Banking Agencies'] view, based on industry research and empirical evidence,

> that these positions *are more likely than recourse positions to be of investment-grade credit quality, and that the banking organizations providing them are more likely to have internal risk rating systems for these credit enhancements* that are sufficiently accurate to be relied on for risk-based capital calculations. 65 Fed. Reg. at 12331. [*Emphasis added.*]

The *Joint Proposal* also noted:

> However, before a provider of an enhancement decides whether to provide a credit enhancement for a particular transaction (and at what price), the provider will generally perform its own analysis of the transaction to evaluate the amount of risk associated with the enhancement. 65 Fed. Reg. at 12329.

B. *Early-Default* Clauses:

The *Joint Proposal* would treat all *early-default* clauses as recourse. In general such clauses warrant that transferred assets will not become default within a stated period.

There should be a limited exception for certain *early-default* clauses that remain effective only for a short period after the assets are transferred. The ability to put back defaulted assets within a short period after closing (e.g., sixty days) should not be deemed to be recourse. Rather such clauses should be viewed as a method of evidencing that the defaulted assets failed to meet required qualifications at the time of closing. A limited exception to the overall treatment of *early-default* clauses as recourse would reduce the likelihood and cost of evidentiary disputes about whether or not a particular asset had passed muster at the time of closing.

C. *Premium Refund* or *Premium Recapture* Clauses:

The *Joint Proposal* specifically requested comment on whether *premium refund* or *premium recapture* clauses should be treated as *recourse*. These clauses do not constitute *recourse*, nor do they meet the definition of *recourse* as defined in the *Joint Proposal*. The *premium refund* provision allows a purchaser to recover its premium paid on any loan that prepays within a stated period. This provision does not require the seller to retain the risk of credit loss on the transferred assets, nor does it address a loan's possible failure to repay. In fact, the provision addresses when the asset has already been paid off (i.e., no credit risk).

A clause allowing a purchaser to recover the premium paid on assets that are prepaid should not be treated as *recourse*. To do otherwise, would confuse reinvestment risk (the risk of being repaid early) with credit risk (the risk of nonpayment).

D. Loan Servicing Arrangements:

In general, the *Joint Proposal* would treat a loan servicing arrangement where the servicer was responsible for credit losses as either *retained recourse* or a *direct credit substitute*. However, those advances that were made by servicers of residential mortgage loans to ensure an uninterrupted flow of payments to investors or the timely collection of the loans would be excluded from such treatment in two instances. The first exclusion would apply where the

servicer was entitled to reimbursement either by a general claim on a party obligated to reimburse or by an unsubordinated claim on the subsequent collections on the loans.

This exclusion is appropriate because the servicer is providing a service to smooth out the cash flows. The servicer is not taking credit risk because it will be reimbursed out of the subsequent cash flows. If subsequent interest flows are not sufficient to cover such advances, then the servicer will also have a claim on principal collections.

This exclusion should not be limited to just residential mortgage servicing and should be allowable for all other asset classes. For example, in many securitizations of commercial loans, it is not uncommon for the servicer to advance interest payments if there is a mismatch between the frequency of the loan payments (e.g., quarterly) versus the asset-backed notes (e.g., monthly). Provided that the servicer always has first priority claim on subsequent cash flows, this service should not be reportable as *recourse*.

The second exclusion would apply where the maximum amounts of nonreimbursed advances on any one loan were contractually limited to an *insignificant amount* of that loan. The term *insignificant amount* is not defined in the regulations as proposed by each of the *Banking Agencies*. The preamble to the *Joint Proposal* does, however, indicate that such an *insignificant amount* would mean no more than one percent of the amount of the outstanding principal on the loan.

The one percent figure set forth in the preamble is too conservative because in the normal course of servicing government insured loans it is not uncommon for servicers to incur losses on servicing advances greater than one percent of the outstanding principal balance. On average these losses will range from one to two percent of the outstanding principal balance of the loans. To impose a one percent threshhold would overstate the *recourse exposure* for every servicer of government insured loans. The resulting capital charges would adversely affect the business of servicing government insured loans. Accordingly, a *safe harbor* provision should be expressly incorporated in the regulations themselves. Under that *safe harbor*, nonreimbursed advances limited to two percent or less of the outstanding principal on any one loan would be treated as an *insignificant amount.*

E. The *Ratings-Based Approach*:

Like the *1997 Proposal*, the *Joint Proposal* would use credit ratings from external *rating agencies* to create a multi-level *ratings-based approach* which would set capital requirements based on relative exposure to credit risk. The *ratings-based approach* would be available for traded asset-backed securities and for traded and non-traded *recourse* obligations and *direct credit substitutes.* The *ratings-based approach* would apply to rated positions and to certain unrated positions "senior in all respects" to a rated position.

The risk-weights that would be so assigned under the *ratings-based approach* are set forth in the table below.

Ratings Category	Examples	Risk Weight
Highest or second highest investment grade	AAA or AA	20%
Third highest investment grade	A	50%
Lowest investment grade	BBB	100%
One category below investment grade	BB	200%
More than one category below investment grade, or unrated	B or unrated	*Gross-up treatment*

As Chase noted in its comments on the *1997 Proposal*, the *ratings-based approach* represents a significant conceptual advance over the current guidelines because it would introduce differentiation in the amount of capital required based on an assessment of the level of credit risk. Still, the *Joint Proposal* continues to be disappointing in that it does not remedy the shortcomings of the *1997 Proposal.*

1. The *ratings-based approach* in the *Joint Proposal* would only apply in certain asset securitizations. A methodology for determining capital requirements based on gradations in credit quality should be developed for bank loan portfolios in general. In this regard, the *Joint Proposal* appears to be a step backward. It is approximately a year since the Basel Committee issued the *Proposed Framework*. That document proposed greater differentiation in required capital charges for a whole range of bank assets not related to asset securitizations. The *Proposed Framework* would provide gradations in capital requirements for bank credits extended to sovereigns, to other banking institutions and to corporate borrowers generally.

2. The *ratings-based approach* in the *Joint Proposal* would provide greater differentiation in capital requirements than that set forth in the *1997 Proposal*. There would be five ratings categories ("buckets") instead of three. Still, the cliff effect where small differences cause large differences in required capital would remain. Indeed, the cliff changes are more abrupt than those proposed by the Basel Committee in the *Proposed Framework*.

The New York Clearing House, the Institute of International Finance ("IIF") and the International Swaps and Derivatives Association ("ISDA") provided extensive responses to the *Proposed Framework*. Chase participated in the preparation of these responses. All of these responses pointed out the need for greater granularity in setting ratings categories. The IIF response noted that most banks' internal ratings systems for corporate credits used at least eight ratings categories and called for the use of minimum of eight such categories when setting capital requirements. The ISDA response set forth an index table, which provides a relatively simple method for incorporating a large number of ratings categories.

3. There are a number of disadvantages to a *ratings-based approach* in comparison to using a bank's internal ratings. Its use should be restricted to those institutions that have relatively low exposure to the asset securitization market and that have not developed internal ratings systems.

Banking organizations that participate to a significant extent in the asset securitization market have developed their own internal ratings systems and analytical models. These tools are more likely to make more sophisticated and accurate evaluations of the bank's credit exposure than a rating provided by external *rating agencies*. Because of their own prudent internal credit analysis of assets held-for-sale, as well as their ongoing relationships with other sellers of assets, such banks will have better access to credit information than a rating agency. Moreover, when evaluating a credit, *rating agencies* put their reputation on the line, while banking organizations put their capital at risk. Indeed the *Joint Proposal*, itself, recognizes that

> Most sophisticated banking organizations that participate extensively in the asset securitization business assign internal risk ratings to their credit exposures, regardless of the form of the exposure. Usually, internal risk ratings more finely differentiate the credit quality of a banking organization's exposures than the categories that the [Banking Agencies] use . . . . Individual banking organizations' internal risk ratings may be associated with a certain probability of default, loss in the event of default, and loss volatility. 65 Fed. Reg. at 12329.

The *Joint Proposal* expresses concern that use of internal ratings raises "give banking organizations an incentive to rate their risk exposures in a way that minimizes the effective capital requirement." This concern is overdrawn. Banking organizations use their internal ratings systems and analytical models to allocate economic capital to reflect the relative risk associated with their assets and off-balance sheet positions. That is, banking organizations put real money at risk based on these systems. It is highly unlikely that banking organizations with strong internal controls would corrupt their internal ratings systems and analytical models merely to improve their regulatory capital ratios.

The *ratings-based approach* places inordinate reliance on a small number of *rating agencies* that are not subject to supervision by the Banking Agencies. Banking organizations have a responsibility to evaluate the credit risk that they undertake, and banking supervisors have a responsibility to review that evaluation process. To some extent, *any ratings-based approach* would delegate this responsibility to private entities not supervised by banking regulators.

Rating agencies and banking organizations often use similar methodologies to evaluate credit risk. Still, there are significant differences in application. Rating agencies consider the credit of a particular issue in isolation. Banks evaluate their positions in light of the concentration or diversification of their portfolios. The *rating agencies* tend to focus on common equity as a measure of capital, while banking organizations consider Tier 1 and Tier 2 capital under the *Guidelines*.

Compared to the internal rating alternative discussed below, requiring a *ratings-based approach* would impose significant additional costs. In many cases, ratings would have to be obtained for no other purpose than to determine the capital required. The cost and delay entailed in obtaining such ratings would put banking organizations at an unnecessary disadvantage when compared to their unregulated competitors.

F. The Internal Ratings Alternative:

Under the *Joint Proposal*, a banking organization could make limited use of its internal risk rating system to determine appropriate capital charges provided the internal system qualified as "adequate" by meeting a number of specific parameters. Unfortunately, the use of such internal systems would be permitted only in unrated direct credit substitutes in asset-backed commercial paper programs. Moreover, such an internal risk rating system could only be used to ascribe risk weights of one hundred percent (100%) or two hundred percent (200%). Such systems would not be permitted to make a determination of a risk weight of less than one hundred percent (100%).

The limitations imposed on the use of internal ratings by the *Joint Proposal* are unjustified. They would only allow a small subset of *direct credit substitutes* to be treated no more favorably than they are under current guidelines. Instead of using internal ratings to move toward a more rational method of setting capital requirements, the *Joint Proposal* would provide banking organizations with complicated methodologies to achieve, at best, the *status quo ante.*

The *Joint Proposal* characterized its proposed relatively limited use of internal risk ratings as "a step towards potential adoption of broader use of internal risk ratings" as discussed in the *Proposed Framework* issued by the Basel Committee. In fact, the *Joint Proposal* represents a regression from the position on internal risk ratings taken by the Basel Committee. The *Proposed Framework* called for *ratings-based approach* using credit ratings provided by external *rating agencies* as the "standardised approach for calculating capital charges at the majority of banks." However, the *Proposed Framework* stated that the Basel Committee believed that "an internal *ratings-based approach* could form the basis for setting capital charges" for sophisticated institutions.

The *Joint Proposal* requests comment on whether to develop procedures for determining whether to allow a banking organization to use its internal risk rating system and the appropriate scope and nature of those procedures. The *Joint Proposal* specifies nine characteristics that are usually present in "adequate" internal risk rating systems. Chase strongly encourages the *Banking Agencies* to develop their methodologies for evaluating the internal risk rating systems of banks. They should work with the industry to insure that reliable internal systems are developed. As an example of industry input on this point, Chase would again call attention to the extensive discussion contained in the ISDA Response to the *Proposed Framework.*

Finally a *ratings-based approach* should only be an interim step toward the use of internal ratings and eventually internal models. In its own right, any *ratings-based approach* using external ratings provided by the *rating agencies* is essentially a dead-end. The vast majority of bank credits are, and will continue to be, unrated. Accordingly, a *ratings-based approach* will not provide a methodology for differentiating capital requirements based on different levels of credit exposure over a bank's entire portfolio or even a broad portion thereof. The only realistic method for achieving that goal requires the use of a bank's internal credit ratings or internal credit models.

G. *Early Amortization Provisions:*

The *Joint Proposal* would impose a *managed assets approach* on certain securitization transactions that incorporate *early amortization provisions*. A bank sponsoring a revolving credit securitization would have to maintain capital against the off-balance sheet assets that it had securitized if such assets were subject to such an *early amortization provision*. For this purpose, an *early amortization provision* would be defined as one that, under specific conditions (generally resulting from the deteriorating asset quality), would require the return of the principal of the assets to investors prior to "the expected payment dates." Under the *managed assets approach* set forth in the *Joint Proposal,* such off-balance sheet securitized receivables would be converted to risk equivalent assets using a conversion factor of one hundred percent (100%) and would then be assigned a risk-weight of twenty percent (20%) -- even if no *recourse* had been retained.

The *managed assets approach* appears to arise out of a concern that *early amortization provisions* may to some extent function like a recourse arrangement to the detriment of the sponsoring bank. The *Joint Proposal* also indicates that the *Banking Agencies* believe that such provisions create liquidity problems because when an *early amortization provision* becomes operative, the sponsoring bank will no longer be able to transfer additional receivables to the securitization vehicle. Finally, the *Joint Proposal* suggests that the foregoing possibility of *quasi-recourse* or liquidity problems could "create an incentive . . . to provide implicit recourse . . . to prevent early amortization." 65 Fed. Reg. at 12330.

Chase is joining with a number of banking institutions and trade associations to provide a joint response (the "*Joint Response*") to the *managed assets approach* that is set forth in the *Joint Proposal*. The *Joint Response* strongly opposes the imposition of capital charges on assets securitized in transactions that incorporate an *early amortization provision*.

It is beyond the scope of this letter to duplicate the extensive analysis of the *Joint Response*. Still, Chase wishes to point out that *early amortization provisions* do not constitute *recourse*. In those cases where the sponsoring bank does provide *recourse,* a capital charge is already imposed and the additional capital required by the *managed assets approach* would be duplicative. To the extent that the *managed assets approach* is addressed toward liquidity concerns, two points should be made. First, the possible inability of a banking organization to transfer assets to a securitization vehicle should be treated no differently from the possibility that a bank might not be able to utilize other funding sources. Second, the *Guidelines* are intended to address credit risk not liquidity risk. Concern about liquidity problems should not be used to justify the increased capital charges imposed by *managed assets approach*. Finally, many transactions contain an incentive to provide *implicit recourse,* but the mere possibility of *implicit recourse* is not *implicit recourse*, itself. On this point, the *managed assets approach* is in direct conflict with the earlier portion of the *Joint Proposal* which states that the *Banking Agencies* "intend to continue to address implicit recourse on case-by-case basis." 65 Fed. Reg. at 12325.

H. *Loan Strips* Sold without Direct Recourse:

The *Joint Proposal* would define as *recourse*:

> Loan strips sold without direct recourse where the maturity of the transferred loan that is drawn is shorter than the maturity of the commitment. *E.g.*, 12 C.F.R. Part 208 Appendix A § III B. 3(a)(viii)(5) (*Proposed*) 65 Fed. Reg. at 12337.

When a bank sells a loan that it has made under a commitment that it has previously extended to a borrower for a specified period, and the maturity of the loan sold is shorter than the outstanding commitment, the loan so sold is deemed to be a *loan strip*. While the commitment remains outstanding, the bank is deemed to retain *recourse* in the *loan strip* even though there is no real *recourse*. *Loan strips* so sold are required to be included in the bank's risk-weighted assets, even though they have been transferred on a nonrecourse basis.

In its response to the *1997 Proposal*, Chase strongly objected to this "constructed concept of recourse," and it reiterates that objection at this time. The fiction that the *loan strip* has been sold with recourse is based on the idea that at maturity of the *loan strip*, the borrower would have an absolute right to draw on the unexpired commitment. However, that is another fiction. The unused commitment (like commitments generally) is only an obligation to advance funds to the borrower in the normal course of business. The unused commitment is not a *direct credit substitute*, and the bank has no absolute obligation to advance funds.

The *Joint Proposal's* rule on loan strips would require that banks maintain capital against credit risks that they have, in fact, transferred. In contrast, the *Guidelines* explicitly recognize the distinction between commitments and *direct credit substitutes*. The conversion factors applicable to commitments are very different from the 100% factor applicable to *direct credit substitutes*. Deeming recourse to exist in the case of such sales of *loan strips* is in direct conflict with the distinction between commitments and *direct credit substitutes*.

When it sells a *loan strip*, a selling bank does not guarantee the repayment of the *loan strip*. If the borrower defaults, then the purchaser would have no claim on the selling bank. Because no credit risk has been retained, the *loan strip* should be considered sold without recourse. There should be no requirement to continue to maintain capital.

Chase submits that the appropriate capital treatment would equate the sale of the *loan strip* with a repayment of the *loan strip* and a corresponding replenishment of the commitment. Banking organizations would have to hold capital on amount of the commitment so replenished. This is because, upon repayment of the *loan strip* at its maturity, the bank would be obligated under the commitment to provide funding to the customer in the normal course of business. This assumes, of course, that the customer will have complied with the applicable terms and conditions in the commitment.

This appropriate capital treatment would result in a significantly different capital requirement than that advanced by the *Joint Proposal*. The anomaly that is created by the *Joint Proposal's* treatment of a *loan strip* can be illustrated by the following example. Assume the following facts:

- A bank has issued a two-year commitment for $10 million and that such a commitment has customary adverse change clauses that relieves the bank of its obligation to fund if specified covenants are breached.
- The customer receives a $8 million draw down for six months.
- The bank sells the loan on a nonrecourse basis to another bank with that participant taking the full credit risk on the loan.

The risk-weighted asset amounts are illustrated in the following table:

	Risk-Weighted Asset Amount Assuming (in thousands)		
	Sale of Loan Using Chase's Suggestion	Sale of Loan Using Joint Proposal	Difference
Gross commitment	$10,000	$10,000	
Less: Amount outstanding	0	8,000	
Net unused commitment	10,000	2,000	
Conversion factor	50%	50%	
Risk weight	100%	100%	
Risk-weighted asset	5,000	1,000	(4,000)
Asset sold with recourse	0	8,000	
Conversion factor	100%	100%	
Risk weight	100%	100%	
Risk-weighted asset	0	8,000	8,000
Total risk-weighted assets	5,000	9,000	4,000

Clearly, the capital requirement determined by following the *Joint Proposal* above is not commensurate with the risk retained. In the case of the sale of a *loan strip*, the selling bank's risk is, at worst, no greater than if the borrower had never made a draw down and the full amount of the commitment were still available. Indeed, the selling bank is actually less exposed to credit risk on the commitment. If the borrower were to default on the *loan strip*, then the purchasing bank would bear the risk of loss. Such a default would more than likely relieve the selling bank from making further advances under the commitment. To assert that the selling bank had increased its credit risk by eighty percent (80%) merely by selling the *loan strip* would not be logical.

III. Summary of Comments:

Chase fully supports the *Banking Agencies'* continued efforts to match capital with actual credit risk. However, we urge the Agencies to incorporate the Basel Committee's *Proposed Framework*, which introduces greater differentiation in required capital charges and applies to bank portfolios in general.

We believe *direct credit substitutes* that provide third-party credit enhancement should be treated as ordinary extensions of credit. Equating such credit substitutes with retained recourse is conceptually flawed, unsupported by evidence of past losses and in conflict with the *Basel Accord* of 1988.

The limitations imposed on the use of internal ratings by the *Joint Proposal* are unjustified. The *Joint Proposal* represents a regression from the position in internal ratings taken by the Basel Committee. Finally, a *ratings-based approach* should only be an interim step toward the use of internal ratings and eventually internal models.

Chase strongly objects, along with other banks, to the imposition of capital charges on transactions that incorporate early amortization provision (the *managed assets approach*). Chase wishes to point out that *early amortization provisions* do not constitute *recourse*. The *Joint Response* provides extensive analysis of the reasons for our opposition of this concept.

The ability to put back defaulted assets within a short period after closing should not be deemed to be *recourse*. Rather such clauses should be viewed as a method of evidencing that the defaulted assets failed to meet required qualification at the time of closing. Separately, a clause allowing a purchaser to recover the premium paid on assets that are prepaid should not be treated as *recourse*. To do otherwise would confuse reinvestment risk with credit risk.

Provided that the servicer always has first priority claim on subsequent cash flows, the service of ensuring an uninterrupted flow of payments to investors should not be reportable as *recourse*. Any nonreimbursed advances limited to two percent or less of the outstanding principal on any loan should be treated as an insignificant amount and therefore should not be treated as *recourse* or as a *direct credit substitute*. Finally, deeming *recourse* to exist when *loan strips* are sold on a nonrecourse basis conflicts both with the realities of the transaction and with the distinction set forth in the *Guidelines* between commitments and *direct credit substitutes*.

In conclusion, Chase appreciates the opportunity to express its views on the *Joint Proposal* and would be pleased to discuss the above comments with the staff of the *Banking Agencies*.

Very truly yours,

Joseph L. Sclafani