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July 5, 2000

Manager, Dissemination Branch
Records Management and Information Policy
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552

Re: Docket No. 2000-15

Dear Sir/Madam:

Over the past two years, I have worked with the Minority Business Development Agency of the U. S. Department of Commerce, the California State Treasurer's Office, the National Economic Council at the White House and the California State Legislature on policy and program developments to promote capital access for minority entrepreneurs and new business owners in underserved markets where capital gaps in funding small and medium-sized businesses persist.

The proposed interagency guidelines on asset securitization and revisions to the risk-based capital treatment for asset securitizations will significantly impede the ability of banking institutions and economic development agencies to expand access to qualified borrowers in the still emerging sectors of our national economy. The fact that these adverse effects are unintended creates an urgent need to review and revise these changes in the proposed rules and guidelines. In California, the chilling effect of these proposed rule changes has already negatively affected interest on the part of existing and potential underwriters and thus needs to be clarified immediately. We should take care not to substitute market distorting regulations for supervisory oversight simply because, as Economics Nobel Laureate Robert C. Merton said, we find it "difficult to deal with change that is exogenous to our traditional knowledge base and framework."

Until recently, banks were able to satisfy their Community Reinvestment Act obligations largely through lending. Revisions in this Act allows banks to satisfy those obligations through investment in securities or investment instruments that accomplish the policy objectives of increasing capital access and enhancing income and wealth formation for underserved entrepreneurial markets. Hence, quality underwriters with specialized vetting and servicing skills in a challenging loan market could attract capital from institutional investors and banks unable or unwilling to serve emerging domestic markets. Proposed changes in capital standards and guidelines affecting asset securitization would eliminate an important market-based policy solution to a long-standing problem of discrimination in business lending and the macroeconomic need to increase funding to new entrants in our entrepreneurial markets.

The theory and practice of creating, evaluating and pricing derivative securities have been in wide use in the US for nearly 30 years. The methodology is not new, and neither is its application to the broadest range of financial services. Adaptations for applying the methodology when the underlying asset is non-tradable have evolved over the last quarter century, including pricing financial guarantees and even the valuation of nonfinancial options. Rating agencies could provide valuation of residual interests in these transactions instead of discouraging banks from creating additional liquidity for the small business sector through securitization. Asset securitizations of this type allow actual financial risk to be spread out over a larger number of lenders. These instruments put banks in control of their credit risk.

What is "new" in this case is that it is the transfer of financial technology to expand access to capital funding for previously excluded groups of businesses. Specifically, derivative-security contracting provides an efficient means for allowing risk sharing to occur among different types of financial institutions. For that reason, the use of these derivative markets for low and middle-income businesses may help form important gateways of access to capital markets and risk sharing. Derivatives and other contracting technologies are playing significant roles in the financial engineering of major economic transitions and restructuring around the world. We should not let the opportunity to enhance the domestic economy slip by.

Several specific points should be considered:

1) the proposed language (reference to "conservative valuation assumptions") utilizes non-GAAP language to evaluate retained interest transactions claimed by the financial institution;

2) the required policies and procedures would discriminate against smaller banks by requiring disproportionate reserve requirements (relative to their size) in order to use securitization as a source of funding;

3) securitization enables banks to increase the velocity of turnover of bank assets through transparent and liquidity creating activities; this establishes enormous flexibility for bank asset management and strategy in developing and serving their customer base in new markets; and

4) asset securitization utilizes proven financial technologies that enable banks to recycle their liquidity and capital invested in loans for small business owners.

Contrary to the assumptions of the proposed guideline changes, there are numerous incentives for a lending institution to manage a quality portfolio of loans. The discipline of the marketplace, together with bank examination and supervision, should strengthen

safety and soundness of institutions in this market, not compromise it.[1] In a typical securitization, a lender can expect due diligence to be performed by investment bankers, established accounting firms, law firms, and two rating agencies. The profitability of the securitization is directly tied to the underwriting quality of the loans since defaults will adversely impact cash flow. In short, securitization increases both the transparency and liquidity of financial institutions.

The proposed guidelines focus on mechanical ratios and reports, not the quality of individual loan underwriting. The market's discipline in pricing and creating liquidity for illiquid bank assets should be embraced as a mechanism to allow banks to carve more channels to the capital markets to increase their portfolio management flexibility and ability to develop new markets, especially for immigrant, women-owned, Asian, Latino, and African-American firms. The FDIC's position creates unintended obstacles to the policy and program development goals of states and the federal government by increasing the cost for financial institutions desiring to engage in the securitization process.

Sincerely,

Glenn Yago, Ph.D.
Director of Capital Studies
The Milken Institute

cc: Jan Owen, Acting Commissioner, California Department of Financial Institutions
Lou Papan, Chairman, Assembly Committee on Banking and Finance, State of California
Senator Richard Polanco, Senate Majority Leader, California State Senate
Ellen Brown, Program Officer, Ford Foundation
Philip Angelides, Treasurer, State of California
Courtland Cox, Director, Minority Business Development Agency, U.S. Department of Commerce
Anita Cooke Wells, Chief, Office of Financial Access, Minority Business Development Agency, U.S. Department of Commerce
Jack Richards, People Manager, Federal Reserve Bank of San Francisco
Kristin Faust, Chief Deputy Treasurer, State of California
Paul Pryde, President, Capital Access Corporation
James Laurie, Stone & Youngberg, LLC
William George, Staff Director, Assembly Committee on Banking and Finance, State of California

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[1] See our recent volume, J. Barth, R. Dan Brumbaugh & G. Yago, *Restructuring Regulation and Financial Institutions*, Milken Institute Press, 2000.