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23

America's Community Bankers®

June 9, 2000

Ms. Jennifer J. Johnson
Secretary
Board of Governors
Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551
Regulation H and Y; Docket No. R-1055

Communications Division
Third Floor
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, DC 20219
Docket No. 00-06; RIN 1557-AB14

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429
Comments/OES; RIN 3064-AB31

Manager, Dissemination Branch
Records Management and Information
Policy
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Docket No. 2000-15; RIN 1550-AB11

Re: Risk-Based Capital Standards; Recourse and Direct Credit Substitutes
65 FR 12319 (March 8, 2000)

Dear Sir or Madam:

America's Community Bankers (ACB) is pleased to offer its comments on the important topic of the appropriate capitalization of recourse exposures and direct credit substitutes under the overall risk-based capital regime imposed on all insured depositories. ACB represents the nation's community banks of all charter types and sizes. ACB members pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.

ACB members, as both issuers and investors in the financial products created by the securitization methods that are the subject of the rulemaking, are vitally interested in the full range of topics covered under this joint rulemaking. The prior rule offered significant regulatory arbitrage opportunities to larger entities heavily engaged in securitization and thereby provided an inadvertent advantage to one size class. ACB believes that the rulemaking should explicitly adopt uniform treatment under the revised capital requirements across the full scale spectrum of depository institutions. ACB suggests a method for ensuring such treatment in the comments offered below.

ACB generally supports the basic direction of the changes proposed in the rulemaking. They would produce desirable uniformity in the approach to the risk exposures across all federal banking agencies and provide clear regulatory definitions of recourse, direct credit substitutes, subordinated interests, and credit derivatives. It has been anomalous to have vital elements of

these important matters handled within the relatively obscure instructions for completing the quarterly Call Reports. The adoption by all four regulators of the approach already used by the Office of Thrift Supervision in requiring equal capitalization of 'originated' and 'purchased' recourse exposures and the adoption of the OTS 'low level recourse' limitation where the maximum contractual exposure acts as a limit on the required regulatory capital charge, demonstrate a laudable, selective approach to consistent regulatory treatment.

To further improve the general approach and to avoid the swing of the regulatory capital requirement between giving undue relief to and requiring excess capital from the sponsors of asset pools. ACB would suggest a savings clause limiting the gross-up requirement. For the most subordinated position (if below investment grade) held by an insured entity that is the original sponsor, some credit should be given to the capital support from the capitalization of the more senior entities so that summing the capital support tranche-by-tranche does not generate a total exceeding some above-100% proportion of the applicable total capital requirement had the sponsoring institution retained the entire amount on its balancesheet.

ACB also suggests reconsideration of the separate capitalization requirement under the 'managed asset' component of the total capital charge and more consistent focus on pure credit risk. The proposal inappropriately and inconsistently includes elements of non-credit risk exposures: the risk addressed under the 'managed assets' heading is a liquidity risk that should be addressed within that dimension of the overall CAMELS examination process. Other components, such as any guarantee of prepayment performance of the underlying loans or refund of premium paid, should be handled by the interest rate risk examination.

ACB agrees that it is appropriate within this rulemaking to provide guidance on the operational requirements under which entities can take advantage of the 'internal models' approach to computing regulatory capital support of risk exposures and clarification of the scope of standard representations and warranties. Finally, ACB agrees with the transition provisions of the proposal. It is only equitable that past transactions continue under the rules in effect as of their consummation.

ACB requests that the agencies move expeditiously to a final rule, taking into account the comments offered by ACB and other interested parties. This is particularly important if the agencies seek to implement the new requirements by year-end. (The end of the calendar year is still the most common choice for fiscal year end.) Adequate lead time for implementation, even with the generous transition provisions included in the proposal, must still be provided. ACB's more detailed comments are offered below.

'Consistency Constraint' as a Benchmark for Capital Treatment

ACB suggests that the agencies consider using an 'adding-up' approach as a standard against which to measure the ultimate reasonableness of their rule. This criterion would require that the total capital support for a securitized pool of assets be calibrated to the support that would be required if those same assets had simply been kept -- and capitalized -- on the balance sheet of an insured institution. Adequate capitalization across the tranches of any securities insured out of

that pool of assets has two dimensions: the total capital requirement and its allocation across those security tranches. Satisfying the 'adding-up' constraint simply suggests that, ideally, the total capital required be neutral as between on-balance-sheet and securitized assets. The agencies have, quite sensibly, proposed that the required tranche-by-tranche regulatory capital support be in line with the actual (or hypothetical) credit rating of the tranches. ACB suggests that the agencies also impose, implicitly or explicitly, this additional adding-up consistency standard as a simple means of achieving neutrality as regards asset capitalization.

ACB appreciates that not all the holders of the created securities will themselves be insured institutions, but some of those investors will be or may become so. In addition, the creators of the securities are often insured institutions or their affiliates and one of the key issues in this entire exercise is how much capital to require for any retained (or credit-enhanced) positions. Keeping the total capital the same and focusing on its appropriate allocation will automatically avoid the creation of the perverse 'regulatory arbitrage' opportunities that the joint-regulator recourse project has been wrestling with for seven years.

This will also automatically ensure that there is no unintended advantage accorded by the regulatory capital regime to larger institutions. Implicitly, the lower capital support that can be achieved by securitization under the existing rules assists those larger entities that are active in this business to the detriment of the smaller operators that compete with them for consumer and business credit extensions. ACB is sympathetic to the argument from larger nationally and internationally active depositories and their affiliates that they must compete with other lenders here and abroad for business. ACB also must emphasize, however, that those same large domestic depositories also compete with community-based banks of all sizes and charter types and that such competition must be on an equitable basis. The provisions of this new joint proposal, especially if refined along the lines suggested here, would come closer to providing that neutral environment.

The allocation of required capital in accordance with the explicit (or 'shadow') credit rating from a nationally recognized statistical ratings organization (or from software 'mapped' to such NRSRO standards) is presumably optimally treated by the 20%, 50%, 100%, 200%, and gross-up categories of the proposal. At least, this treatment is the one where joint agency agreement has been achieved. It would be useful to discuss in the preamble of the final rule the extent to which the revised treatment exceeds or falls short of satisfying the 'adding-up' consistency constraint. Some simple calculations based on the data from a small sample of various asset-backed securities issuances seems to confirm that the total capital required by securitized assets seems closer to the hypothetical value had all assets been retained on-balance-sheet. Now, however, that revised treatment often overshoots the total capital mark, though by less than the current treatment may undershoot it. A more rigorous discussion and explication by the regulators would be enlightening.

ACB appreciates that, especially for the on-balance-sheet treatment, the US banking regulators are bound by the provisions of the Basel accord on capital regimes. Still, the appropriate method for fixing the undoubted shortcomings of the calibration of the capital weights under that overall

system is to work directly on those weightings, not to provide back-door and selective relief to some methods of financing or securitizing assets.

ACB has recently commented most forcefully on the latest proposed revisions to the Basel Accords. ACB believes that the adoption of an approach akin to that of this joint agency rulemaking to recourse and direct credit substitute exposures is vital to maintaining the credibility and consistency of the entire Basel system. Unfortunately, that overall Basel proposal, while consistent with this proposal, does not conclusively mandate it. ACB urges those federal bank regulators that participate in the development of those refinements of the Basel Accords to argue for the adoption of this more definitive approach.

The secondary market and asset securitizations offer an excellent mechanism for identifying, isolating, allocating, and diversifying overall risk and its components. These techniques should be used where there is a genuine economic benefit, not where there is merely an opportunity to game the system. Adopting this proposal, with relatively modest adjustments, will help ensure that this standard of genuine economic function will be met.

Equivalent Risk Treated Consistently

ACB strongly endorses the (re)definitions of recourse, subordination, direct credit substitute, credit derivative, and the consistent use of the low level recourse cut-off for required capitalization. These clarifications will place the definitions and general approach in a more appropriate location than in the instructions for completing the Call Report. More substantively, they also will take a major step in achieving consistency of treatment across exposures from originations, purchases, and from providing credit enhancements to equivalent credit risks.

This consistency is shown throughout the proposal. ACB welcomes the explicit clarification on the treatment of participations in direct credit substitutes. Generally reasonable treatment is provided for both the selling and purchasing entity is provided.

The general rule of viewing risks as being restructured and reallocated when no longer *pro rata* to the relative shares of the total asset footings outstanding is completely consistent with the intuitive sense of regular risk sharing and reasonably distinguishes cash flow timing restructuring from credit exposure reallocation. The sequential pay structure seen in a typical REMIC or CMO pool does reallocate the 'credit exposure years' from the very fact of the differential redirection of the total cash flows but, if any credit loss incurred is immediately allocated across the then-outstanding securities, there is no reason to regard the securities time-sequencing as credit subordination.

Risks Other than Credit Risk

ACB supports the approach of the proposal to the definition and exclusion of 'standard reps and warranties'. These are appropriately excluded from the scope of the required capital support and the proposal carefully and reasonably safeguards against the open-ended extension of these reps and warranties to back-door support from the securities issuer/originator.

By focusing on actions within the control of the provider of these standard reps and warranties, such as normal underwriting procedures and maintenance of customary documentation, the proposal offers a reasonable bright-line test that is more easily policed that the vaguer notion of 'industry standard'. As the proposal seems to recognize, industry standards can quickly adapt to any capital-economizing opportunities that the regulatory language can be stretched to cover.

The proposal also takes a very reasonable approach to the documentation of the operational requirements that are created by these reps and warranties and puts entities on notice that this aspect of operational controls will be subject to examination.

The broader issue of implicit recourse is rather slippery and less susceptible to conclusive resolution. ACB regards contractual obligations as generally controlling. If times get hard, the willingness of security issuers to accommodate any investor group beyond their contractual obligations to do so will disappear very quickly. If, however, there is some substantial administrative benefit to the issuer from going beyond the strict contractual requirements at nominal economic cost, that should actually be encouraged by the regulator, even for capital-deficient entities.

ACB supports the case-by-case approach of the proposal to implicit recourse. It would be helpful if the agencies were to provide a running commentary on the cases where they have deemed issuer actions to be implicit recourse. As an adjunct to such data gathering and disclosure by the agencies, it would be reasonable for securities issuers to be required to retain records of their actions in going beyond contractual requirements in accommodating investors, the reasons for these actions, and the extent to which any pattern of issuer action has thereby been created on which investors could conceivably rely.

By contrast, ACB does not support the 'managed assets' provision of the proposed rule. ACB has standing to comment on the inequity of this provision since, at many points of this comment, we stress the need to be aware of the equity of the treatment across various size classes of entities. This new capital requirement is actually unfair to those large entities that routinely engage in securitizations.

The proposal correctly identifies the funding risk that may be created by an 'early amortization' provision. When the stipulated event occurs, the securities pool sponsor does lose the opportunity to fund further credit extensions by additional securities issuance. (The proposed capital requirement with respect to an early amortization provision is to be distinguished from the 'capital precommitment' concept whereby entities propose the required level of capital for a given level of actual footings in a trading account and are put on 'regulatory report' in the event that actual or value-at-risk fluctuations exceed this precommitted level: the proposal here keys off potential footings as well as the potential risks from actual footings.)

The imposition of a capital requirement with respect to assets securitized using an early amortization feature appears to be based primarily on a concern that the early amortization feature creates implicit recourse to the sponsoring bank. An early amortization provision does

not represent a credit risk and an effect of the proposal's treatment would be to impose a capital requirement that is redundant to that imposed under the low-level recourse rule with respect to the credit enhancements that are normally required by rating agencies. Credit enhancements are generally of two types: A credit enhancement could be considered to be built into the structure of the securitization vehicle by the existence of subordinated classes of securities. To the extent that such subordinated instruments are not held by the bank or its affiliates, there is no credit risk to the bank. What is generally referred to as credit enhancements are the spread accounts funded either by a direct contribution from the sponsor or by the appropriation of a portion of the asset revenues. To the extent that such spread accounts are carried as assets on a bank's balance sheet, capital must be held dollar-for-dollar under the low-level recourse rule.

ACB agrees that triggering an early amortization provision will create a loss of funding that could necessitate tapping alternative funding sources to avoid a liquidity problem for the bank. The risk-based capital rules were not created, however, to address a future liquidity problem that is highly contingent, given the myriad of short-term funding sources available to a bank. Nevertheless, to the extent that credit or liquidity risks creates an incentive for the bank to make available implicit recourse to avoid triggering the early amortization feature, it is still not appropriate to impose an automatic capital requirement, absent evidence that providing implicit recourse is widespread. The only appropriate means to deal with the possible existence of implicit recourse is on a case-by-case basis under the powers the regulators already have.

ACB would suggest as an alternative approach that each revolving pool sponsoring entity maintain a record of its exposures under 'early amortization' clauses and that this record be routinely reviewed as part of the liquidity component of the CAMELS examination. The appropriate calibration of the maximum exposure under the draw-down of, say, the credit limits of a credit card revolving pool will be a source of endless disputes anyway. The more flexible approach of considering this as a dimension of the liquidity planning for the sponsoring entity is likely to generate a more cooperative relationship between the regulator and the entity.

Inappropriate Inclusion of Certain Risks

Despite ACB's general support of the proposal's treatment of reps and warranties and implicit recourse, ACB does not concur that the proposal does in fact limit its coverage of risk "only to arrangements that create exposure to credit or credit-related risks." In several places, the proposal sweeps into its coverage risks that are related to interest rate or liquidity risk, not to credit risk under even broad definitions of that term.

For example, ACB views the treatment of stripped securities as inconsistent with the credit risk focus of the proposal. Here the issue is exposure to interest rate risk (IRR), rather than credit risk. ACB would agree that the IRR exposure of interest rate strips is extreme in that, unlike other debt securities, there is no guaranteed rendezvous between the amount paid for the item and its recovery over time or at maturity, but this argument surely does not apply to principal-only strips. Thus ACB questions the automatic exclusion of these items from eligibility for the lowest credit risk weights. To put the issue most starkly: what if these strips are created from Ginnie Mae securities?

Nor is credit risk an issue for premium refund clauses: this is an IRR issue and should be treated under that heading. There is no conceptual difference between these exposures and those under swap contracts. (The issue of the credit status of counterparties on swaps that are 'in the money' is separate and is indeed a genuine credit exposure.)

Servicer Cash Advances and 'Early Default' Provisions

ACB does support the inclusion of 'early default' clauses within the scope of recourse exposure. The proposal explicitly offers ways for issuers to limit the scope of these warranties and limits their treatment as recourse to the period for which they apply. In addition, to the extent that these clauses are subject to a limit on how much collateral substitution or other cure will be offered, the limit of the low-level recourse provision will be available. Should that limit not be enough for a month or two's early default exposure, the entire pool is likely to be a candidate for a gross-up anyway.

The treatment of reimbursable servicer cash advances is also well founded. Insignificant amounts of non-reimbursable servicer cash advances (under 1% of principal balance) are also exempt. The agencies, however, may want to consider some aggregation rule for those 'insignificant' amounts: if enough pools are serviced, the "one-percents" here and there could add up to more substantial exposures.

The rule is sensible in requiring that the servicer reimbursement not be subordinated to other investor claims in order to obtain exemption from recourse. If, *a fortiorari*, those servicer claims have priority on the cash flows from the proceeds of collateral liquidation, these amounts should not be considered at risk.

ACB concurs in the treatment of retained interests in spread accounts that are booked as assets by the servicer/sponsor of the revolving pool generating the securities. Since these spread account assets are, by definition, subordinated to provide added credit support, treatment as recourse exposure is entirely appropriate.

Interaction with the Market Capital Rule

ACB suggests that care should be taken by the agencies offering a special rule for the credit risk capitalization of trading account items. This should not become an escape route from the required capitalization of recourse exposures. In particular, ACB suggests that the agencies reconsider the otherwise sensible dropping of the fourth component of the treatment of non-traded and non-rated positions. If the position is non-rated and is not exposed to the market by at least partial sales, then that position arguably should not be eligible for inclusion in the trading account and separate market risk category.

Treatment of Privately-Issued Mortgage-Backed Securities

ACB had long petitioned the banking agencies to reduce the required capital support for the highest-rated 'private label' MBS to the 20% category. This reduction was consistent with the overall provisions of the almost 20-year old Secondary Mortgage Market Enhancement Act. The overall ratings-based approach makes the relatively recent decision to allow the 20% risk weight to private label MBS backed by Fannie Mae or Freddie Mac pass-throughs redundant, as the agencies note. It should eliminated in favor of the broader eligibility under the ratings approach.

ACB would simply suggest that this item be reconsidered as a restored exception in the event that the lowest risk weight otherwise achievable under that ratings approach is subsequently increased from that 20% level.

Treatment of Rated Positions

Subject to the above discussion of the need to make some attempt to ensure that any gross-up treatment is no further away than some predetermined limit of non-neutrality as regards relative capitalization of on-balance-sheet vs. securitization options, ACB sees the relative risk weights as reasonable. In some instances, especially in mortgage loan pools, the securitization will never include a below-investment-grade tranche because of the high quality of the underlying collateral/loans.

ACB concurs in the proposed treatment of unrated positions that are senior to rated positions (though how often such cases will arise is perhaps debatable). ACB would, however, suggest that there is some abuse potential in the use of short-term repo transactions to validate the tradability of a security tranche. At the very least, that repo should occur with a fully independent third party: the securities house underwriting the issue or doing other business with the pool sponsor may not be independent enough to qualify.

Non-Traded and Unrated Positions

ACB generally applauds the creativity and flexibility that the proposal shows in these areas. The treatment of split ratings and the elimination of the fourth criterion for non-traded positions (discussed in the preamble at p. 12328) represents creative movement from the 1997 proposal. The most significant change, however, is the allowance of internal risk models to qualify for the ratings-based capital support.

The proposal envisages two approaches to the qualification of internal models for this capital computation purpose. The first will typically be available to large and sophisticated banking organizations doing significant securitization business and with a long experience and large database covering probability of default, probability of loss on default, and the variability of those probabilities from both a statistical and economic scenario perspective.

Such internal systems, while not necessarily restricted to NRSRO categories, must meet nine requirements to qualify for this purpose:

1) be integrally linked to the risk management system of the entity;
2) be linked to objective and measurable outcomes;
3) consider both the underlying borrower default/loss risks and the impact on the separate securities tranches;
4) cover all categories of assets , not just those falling into the bank regulators' adverse 'asset classification' groupings;
5) allocate assets/positions into explicit risk grades using clear definitions, even for subjective quality indicators;
6) include independent review by independent expert outsiders or by expert staff separate from the loan/asset origination group and those developing the internal model itself;
7) include internal audit procedures to ensure that the model output is used to rate credit quality;
8) track the performance of loans/assets to validate and adjust risk grading procedures; and
9) use credit rating standards at least as conservative as those of the ratings agencies.

These standards are reasonable, individually and as a group. The agencies have requested input on whether it would be helpful or necessary to create a separate listing of review and approval procedures to permit entities to avail themselves of internal models for this capital computation purpose.

ACB would suggest that, rather than provide yet another checklist, the agencies simply request prior notification from any entity within their jurisdiction that the entity intends to commence use of an internal models approach for this purpose. (The notice should go to both the agency headquarters in Washington, to the relevant regional office, and to the examiner in charge, if known.) The entity should indicate that it has prepared documentation that addresses these nine requirements and, in turn, the agency should be given a reasonable time to deny such use. If no such denial is forthcoming, the entity should be allowed to proceed on this basis and the results of the exercise will be subject to review at the next scheduled examination.

Since the proposal explicitly reserves the right of each agency to preclude further use of an internal model approach that is found deficient and to overturn retroactively any capital relief thereby claimed, the risk exposure of the banking sector on this score should be relatively modest. Remember that, on average, the entities likely to avail themselves of this opportunity are only six months away from an examination or even have full-time federal examiners on the premises.

Furthermore, the results of internal models may be used to qualify for only the 100% or 200% risk weights: the 20% and 50% values are off-limits for this approach.

The second way that internal models would be available is via the use of special 'external' software explicitly mapped to the requirements of one or more of the NRSROs. Presumably, those ratings agencies themselves would be willing to provide such software: they are already quite forthcoming about the overall standards used to attain various levels of credit quality under their ratings process. Such approved software could be embedded in other software systems of

the banking institution via its in-house computer software inventory or within the offerings of its outsourced provider.

In some respects, validation of this software by the banking agencies would be an easier task that verifying the compliance of more extensive internal proprietary models developed in-house by large active issuer entities. Since this option can bring the internal models approach to the masses of smaller entities, ACB strongly supports its retention within a final rule and appreciates the willingness of the agencies to develop this option.

Again, models mimicking ratings agency procedures would not be allowed to qualify positions for the 20% or 50% risk weights. This again shows the careful attention to consistency within the overall proposal.

ACB accordingly is somewhat puzzled by the exclusion of recourse exposures from the internal models approach. There seems to be no reason why such positions cannot be assessed by this approach: this exclusion will simply recreate incentives to refashion recourse into equivalent direct credit substitute exposures. ACB requests either the expansion of eligibility to recourse exposures or at least some justification for their exclusion.

Effective Dates

ACB welcomes the flexible approach to implementation that the proposal offers: any benefits can be claimed retroactively, but no burdens will be imposed on a look-back basis. Furthermore, the applicable date for new transactions will be the effective date of the final rule. ACB would suggest that it might be useful to select a quarter-end date for the eventual effective date and, as noted above from an 'ideal world' perspective, to offer some implementation lead-time.

Clarity of Language

Pursuant to Section 722 of the Gramm-Leach-Bliley Act, the agencies have requested comment on the clarity of the proposed treatment. ACB feels that, given the complexity of the issues addressed by the proposal, the proposal outlines the rationale for the changes in these areas of the capital regime very clearly. The topics where ACB requests further analysis or discussion are noted above. ACB hopes that this letter has done an equally effective job in laying out its views on these important issues.

If you have any questions regarding those views or on related areas, please call me at 202-857-3118, or Jim O'Connor at 202-857-3125.

Sincerely,

Brian Smith

Brian Smith
Managing Director,
Policy Development