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Office of Thrift Supervision
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World Savings Bank, FSB, Oakland, California ("World"), appreciates the opportunity to comment on the agencies' proposal to revise risk-based capital requirements for recourse obligations, direct credit substitutes and securitized transactions that expose financial institutions to credit risk. We strongly endorse the agencies' proposal to treat recourse obligations and direct credit substitutes more consistently than the current rules. Indeed, there should be no difference in the risk-based capital requirement for holding the assets or transactions with recourse or direct credit substitutes.

By way of background, the Risk-Based Capital Regulations became effective in 1990. While the rules brought regulatory capital requirements more in line with the level of risk taken by insured institutions, the rules have not been fully effective in ensuring that insured institutions hold the level of capital that was intended for the level of risks taken. Unfortunately, there remained a loophole in the regulations relating to the amount of capital required on direct credit substitutes. The agencies issued proposals in 1994 and 1997 which would have corrected the problem with direct credit substitutes, but no final rule was issued in either instance. Consequently, institutions continue to structure arrangements with direct credit substitutes that reduce the amount of risk-based capital required for a given level of credit risk. As a result, the risk-based capital required at some institutions is less than the regulations intended. Indeed, without the high leverage capital requirements for insured institutions, capital levels might be dangerously low.

There is no hard data on how much risk-based capital requirements were reduced in the 1990's through the use of direct credit substitutes. Fortunately, the risk-based capital deficiency has not been an issue because of the incredibly strong economy. However, strong economies don't last forever. At some point there will be a recession and the undercapitalization may result in failures and losses to the insurance fund. Thus, it is critical for the agencies to implement a final rule this time.

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The most important element of this proposal is equalizing the risk-based capital treatment of recourse obligations and direct credit substitutes. Allowing institutions to lower their overall risk-based capital requirements simply by utilizing types of credit enhancements that currently receive more favorable risk-based capital treatment than traditional recourse smacks of pre-FIRREA capital practices and ultimately could lead to the same disastrous results.

While the proposed rule is sound, both insured institutions and Wall Street will continue to develop new credit enhancement products and mechanisms that may not fall neatly into categories defined in the new risk-based capital rules. Therefore, the agencies need to be vigilant in their review and analysis of these "novel" transactions and instruments to ensure that the level of credit risk is appropriately measured. Consequently, it's very important to include language, as proposed, to clarify the agencies' authority to determine the appropriate risk-weight for assets and credit equivalent amounts on a case-by-case basis. In addition, while the current proposal calls for prospective application, the amount of risk-based capital deficiency built up over the past decade warrants a close review of insured institutions in the examination process to ensure risk-based capital levels do not present a safety and soundness issue, particularly for institutions which have been active in securitizations and other credit risk arrangements.

The proposed usage of a ratings-based approach for privately-issued mortgage-backed securities ("MBS") and the proposed risk-weightings for each rating make sense for rated securities. However, it may not work for unrated securities. Internal models may be helpful in determining rating equivalents and appropriate risk-weightings but they must be reviewed by examiners both for accuracy and reasonableness of assumptions. At the very least, credit risk arrangements "rated" with internal models should have a minimum risk-weighting of 100% as currently proposed. Furthermore, because asset portfolios can be carved up into multiple securities, the agencies must be careful to prevent the ratings-based approach (external and internal) from being used by financial institutions as a vehicle to lower their overall risk-based capital. This suggests that the "gross up" treatment should be applied to each securitization to ensure adequate capital is required. In particular, examiners must carefully evaluate privately-issued MBS to ensure that the total risk-based capital allowed under the proposed rules is no less than what the risk-based capital requirement would be for the underlying assets.

Another potential problem is created by securitizations and risk-sharing agreements that start out with the risk assigned to specific tranches, or parties, and then change over time as the underlying pool of assets pays down, defaults, and experiences credit losses. For example, it is common to securitize into senior Tranches which are rated AA or AAA and back those up with subordinated tranches which hold specified levels of credit risk and receive lower ratings. As the underlying assets season, credit losses and pay downs may reduce the subordinated tranches that are supposed to absorb the credit risk. If these subordinated tranches are depleted, the remaining credit risk can move to the higher-rated senior tranches. As a result, the risk-based capital rules need to be dynamic enough to change the capital required by the senior tranches as the structure of the underlying assets changes so as to continue to require an appropriate level of risk-based capital. The ratings-based capital approach should take care of this issue for rated securitizations, but unrated securitizations and similar arrangements are at risk unless the structures are monitored internally, with regular reviews by examiners.

In conclusion, World wholeheartedly supports the agencies in their efforts to update risk-based capital standards to equate risk-based capital requirements for recourse and direct credit substitutes and urges the agencies to implement the rule this time!

Very truly yours,

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