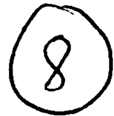
40 Broad Street
New York, NY 10004-2373
Telephone 212.440.9400
Fax 212.440.5260
www.bondmarkets.com

Washington Office:
1445 New York Avenue, NW
Washington, DC 20005-2158
Telephone 202.434.8400
Fax 202.434.8456

European Office:
25 Old Broad Street
London EC2N 1HN
Telephone 44.20.78 77 20 80
Fax 44.20.78 77 20 88



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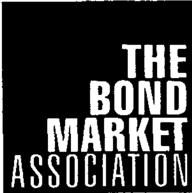

December 22, 2000

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Ave., N.W.
Washington, D.C. 20551

Docket No. 00-17
Communications Division, Third Floor
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

Robert E. Feldman
Executive Secretary
Attn: Comments/OES
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Manager, Dissemination Branch,
Information Management and Services Division
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attn: Docket No. 2000-70

Re: Proposed Rules Concerning Capital Treatment of Residual Interests Retained In Asset Securitizations and Other Transfers of Financial Assets

Ladies and Gentlemen:

The Bond Market Association[1] welcomes the opportunity to comment on the above-referenced capital regulations proposed jointly by the Office of Comptroller of the Currency, the Department of the Treasury, the Board of Governors of the Federal Reserve

[1] The Association represents securities firms and banks that underwrite, distribute and trade debt securities domestically and internationally. The Association's member firms account for in excess of 95 percent of all primary issuance and secondary market trading activity in the U.S. debt capital markets, including the issuance, underwriting and trading of securitized instruments. The views expressed in this letter reflect input received from a broad range of Association members who are active in the securitization market, including members of the Association's Mortgage and Asset-Backed Securities Capital Adequacy Task Force. More information about the Association and its activities may be obtained from the Association's Internet website, located at www.bondmarkets.com.

System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision (collectively, the "Agencies").

I. Introduction and Executive Summary

In general, the Agencies' proposals would amend current capital rules to:

(1) require a regulated institution to hold dollar-for-dollar capital against the full amount of residual interests retained in connection with securitizations or other transfers of financial assets[2], even if the capital charge exceeds the full risk-based capital charge typically held against the transferred assets; and

(2) limit to 100% the aggregate amount of residual interests, mortgage servicing assets, non-mortgage servicing assets and purchased credit card relationships, and separately limit to 25% the aggregate amount of residual interests, non-mortgage servicing assets and purchased credit card relationships, that in either case could be included in an institution's Tier 1 capital for both leverage and risk-based capital purposes.

"Residual interests" are defined in the proposals as balance sheet assets that represent interests (including beneficial interests) in transferred financial assets that are retained by a seller after a securitization or other transfer of those assets, and which are structured to absorb more than a pro-rata share of credit losses related to the transferred assets through subordination provisions or other credit enhancement techniques.

The Agencies state that the proposed rules are intended to better align regulatory capital requirements with the risk exposure of these types of residual interests, encourage conservative valuation methods and restrict excessive concentrations in these assets. These steps are intended to address three specific areas of continuing supervisory concern:

(1) Inappropriate or aggressive valuations of residual interests;

(2) Inadequate capital in relation to the risk exposure of the organization retaining the residual interest; and

(3) Excessive concentrations of residual interests in relation to capital.

The Association recognizes the Agencies' fundamental policy goal of ensuring the continuing safety and soundness of institutions they regulate, and acknowledges the specific supervisory concerns that underlie the promulgation of these proposed rules. However, the Association believes that these proposals are overly broad in their application and, as a consequence, would be needlessly penal and distortive in their likely effect. In particular, we believe that the universal application of these rules to *all* residual interests (as defined in the proposals) retained by *all* regulated institutions in securitization transactions may exacerbate, rather than reduce, capital and liquidity pressures on many such institutions and restrict, rather than enhance, their ability efficiently to fund their lending

[2] The proposed rules would be limited to securitizations and asset transfers that are characterized as sales under generally accepted accounting principles ("GAAP").

activities within acceptable capital and risk management limits. We are concerned that adoption of the proposals would result in a higher cost of capital, and ultimately, higher borrowing costs.

In light of these concerns, we offer several recommendations within this letter to narrow the focus of the Agencies' proposed rules. In particular, the Association:

- **Opposes** the adoption of dollar-for-dollar capital requirements and Tier 1 capital limitations for residual interests, on the basis that the application of such rules would be overly broad and unnecessarily restrictive for many institutions;

- **Supports** the exercise by the Agencies of their discretionary supervisory authority to impose extraordinary capital requirements on those institutions and transactions deemed to pose unacceptable levels of credit and liquidity risk;

- **Urges** the Agencies to allow retained residual interests to qualify for more favorable risk-based capital treatment under both external and internal ratings-based criteria now being considered by domestic and international bank supervisors;

- **Opposes** the aggregation of residual interests with other types of servicing and non-servicing assets for purposes of computing Tier 1 capital limitations;

- **Conditionally Supports** (should the Agencies nevertheless impose additional risk-based capital requirements on retained residual interests) a narrower application of any new rules to require additional capital only to the extent of any incremental credit risk that is created via securitization; and

- **Urges** the Agencies, should they ultimately adopt rules that increase regulatory capital requirements for retained residual interests, simultaneously to adopt appropriate grandfathering and transitional rules to mitigate the economic dislocations that banking organizations would experience if the rules were enacted with immediate effectiveness.

II. Interests of the Association and Securitization Market Background

The Association's members include both banks and securities firms who are active in a wide range of asset securitization activities. As securitization issuers and dealers, bank members of the Association would be directly subject to the Agencies' proposals. As providers of investment banking, securities underwriting, distribution, trading and other capital markets services to banks and other financial institutions that are engaged in asset securitization activities, the Association's securities firm membership would also be impacted by these proposals. Both categories of the Association's membership thus have fundamental interests in preserving an adequate safety and soundness cushion for regulated institutions, while simultaneously promoting economically efficient securitization markets.

As the Agencies themselves have recognized, securitization can serve as an efficient means of financial intermediation.[3] The Association agrees, and believes that securitization has proven its value as an efficient funding and capital management mechanism. It can also be an effective means for banks to redistribute the inherent credit and market risks they face to investors and the broader capital markets, thereby facilitating prudent risk management and diversification.

Securitization transactions structured as sales facilitate the removal of assets from bank balance sheets, thereby reducing capital requirements and enabling banks to allocate and utilize their capital more efficiently. However, securitization is also frequently a more efficient and flexible financing option in comparison with others available to banks. For example, the ability of a bank issuer to subdivide and redirect cash flows from underlying assets among a range of sold and retained interests can provide it with both cheaper funding and the ability to achieve a more precise matching of the duration of its assets and liabilities.

From a broader economic and systemic perspective, the existence of efficient securitization markets has been demonstrated to have the effect of increasing the availability, and reducing the cost, of financing in the primary lending markets. Efficient securitization markets serve to reduce disparities in the availability and cost of credit, by linking local and regional credit-granting activities to a national, and increasingly, global, capital market system. Securitization thus subjects the loan origination and credit extension functions of individual financial institutions to the pricing and valuation discipline of the capital markets. This promotes the efficient allocation of capital and management of risk within those institutions, while serving to mitigate systemic risk throughout the financial system as a whole. Consumer and business borrowers—the clients of banking institutions—benefit directly from the increased supply and lower cost of loans.

In view of these important micro- and macro-economic benefits, the Association regards it critically important for regulatory capital regulations to avoid imposing unnecessary restrictions on the ability of banks to benefit from the application of securitization techniques to fund their lending operations efficiently.

III. Discussion of Proposed "Dollar-for-Dollar" and "Tier 1" Proposals for the Capital Treatment of Retained Residual Interests

A. Dollar-for-Dollar Requirements

The Association's principal concern with the Agencies' dollar-for-dollar and Tier 1 proposals is that they are overly broad, and would in our view result in unduly penal and distortive capital requirements to be imposed on residual interests retained in securitization transactions.

Specifically with reference to the dollar-for-dollar proposals, the Association believes—supported by the direct experience of many of our bank members—that most regulated financial institutions who are significantly engaged in asset securitization activities have

[3] For example, in "Interagency Guidance on Asset Securitization Activities" (December 13, 1999), the Agencies noted that financial institutions "have been using asset securitization to access alternative funding sources, manage concentrations, improve financial performance ratios, and more efficiently meet customer needs."

established and effectively carry out appropriate policies and procedures for valuing retained residual interests and managing liquidity, concentration and other related risks. In this context the Association believes that the proposals represent an overreaction to regulatory concerns precipitated by perceived deficiencies within a more limited number of smaller, less sophisticated and less vigilant institutions.

Not only do valuation, risk and liquidity management capabilities among institutions vary considerably, so too do the credit and liquidity risks presented by different types of residual interests. Such interests range from interest-only strips to subordinated securities to cash collateral accounts to other forms of credit enhancement, each of which may present distinctive credit risk, liquidity and valuation issues and challenges to the institution that creates and retains them.

To the extent that the Agencies' policy goal of ensuring that appropriate capital is held against retained residual interests is tied to concerns about the credit quality of specific categories of underlying assets—for example, subprime residential mortgage and home equity loans—the Association believes that those concerns would be better addressed by dealing with those asset types directly, and if necessary, implementing more stringent supervisory guidance or regulatory capital requirements. The Agencies' proposals instead would effectively regulate and constrain subprime lending activities indirectly, through the unnecessarily broad application of increased capital requirements to all residual interests, regardless of the perceived credit quality and related supervisory concerns associated with the assets to which those interests relate.

Unfortunately, we believe that the mere pendency of these proposals is already having a distorting impact on at least some institutions to whom the new rules would apply. These distortions affect business decisionmaking about lending programs and asset concentrations (e.g., subprime versus prime loan programs and assets) as well as the economic structure of securitization transactions supported by those assets. For example, a subprime home equity issuer may be able to maximize its funding efficiency by issuing triple-A securities. Such an issuer may be effectively prevented from realizing that goal, since the size of the subordinated residual interest needed to provide sufficient credit enhancement for those securities would (if retained by the institution) produce non-economic regulatory capital consequences.

Moreover, the fact that a bank has retained a residual interest in securitization transaction does not necessarily mean that the instrument or the assets that underlie it are exceptionally risky. Neither does it suggest that the bank is unable to accurately assign a value the interest, or to sell it to an investor should it choose to do so. Instead, the economic characteristics of a residual interest and the decision to retain it on balance sheet are often driven principally by cost-of-funds considerations peculiar to the institution and individual securitization transaction. Accordingly, the retention of a residual interest should not in all circumstances signify the need for additional regulatory capital beyond that already required under the Agencies' existing rules.

The Association believes that a narrower and more targeted response would be appropriate, rather than regulating to the "lowest common denominator." Instead of imposing dollar-for-dollar capital requirements for all retained residual interests, we recommend that the Agencies rely on their existing authority, as further clarified in the current pro-

posals, to act on a case-by-case basis to impose additional capital requirements. In this way, we believe that exceptional capital requirements would be imposed only where they are warranted by the risk profile of a particular instrument or the risk management capabilities of a particular institution.

A requirement to hold dollar-for-dollar capital against a residual interest would be particularly inappropriate where that interest would qualify for more favorable risk-based capital treatment pursuant to guidance proposed both by the Agencies[4] and the Basel Committee of the Bank for International Settlements.[5] In each of these proposals securitization positions rated investment grade (generically, triple-B minus or better) by an external rating agency would qualify for a risk weighting of 100% or less. Each proposal also suggests the possible expanded use of internal ratings to qualify for similar risk-based capital treatment.

The Association has generally endorsed these proposals,[6] and agrees with the Agencies that differences in the residual interest proposal and prior securitization proposals should be reconciled. We believe that such a reconciliation should allow for the use of external ratings and, where an institution can demonstrate the integrity of the criteria and procedures used, internal ratings to qualify residual and other retained securitization interests for more favorable risk-based capital treatment. Whatever the outcome of the Agencies' current residual interest proposals, we believe that any new rules that are adopted should be superseded by broader risk-based capital regulations linked to the application of external and internal rating system criteria, where the application of such criteria would result in more favorable capital treatment for the institution.

B. Tier 1 Requirements

The Association also opposes the Agencies' proposal to include residual interests with other servicing and non-servicing assets counted toward Tier 1 capital and the proposed aggregate 100% and 25% limits on such assets. Moreover, we do not believe that the Agencies have articulated a sufficient policy rationale for proposing to include residual interests with these other asset types for purposes of computing Tier 1 capital limitations.

We believe these additional requirements would be inappropriately additive, duplicating existing capital requirements already applied to residual interests. In some cases the application of this new requirement, coupled with the new dollar-for-dollar rule, would force a bank to hold capital at a level greater than its maximum recourse exposure. We do not believe that there is any circumstance in which the regulatory capital required to

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[4] *See* "Proposed Revisions to Capital Standards Governing Recourse Arrangements and Direct Credit Substitutes," 65 Fed. Reg. 12320 (March 8, 2000).

[5] *See* "A New Capital Adequacy Framework," Consultative Paper Issued by the Basel Committee on Banking Supervision, June 1999.

[6] See letters dated June 7, 2000 from the Bond Market Association to the Agencies regarding "Proposed Revisions to Capital Standards Governing Recourse Arrangements and Direct Credit Substitutes and March 31, 2000 from the European Securitisation Forum to the Bank for International Settlements regarding A New Capital Adequacy Framework"

be held against a securitization position should exceed the maximum potential contractual claim against the institution.

The recognition of gain-on-sale assets is required under GAAP, which is applicable to regulated banking organizations and non-depository institutions alike. As discussed earlier, we believe that most larger and more sophisticated banking organizations have established reasonable methodologies and maintain appropriate valuations of gain-on-sale assets and other retained residual interests. Accordingly, we believe that limiting the amount of such assets that may be counted toward Tier 1 capital would place those organizations at a competitive disadvantage in comparison with their non-depository institution competitors, who operate subject only to the capital constraints imposed by market forces, economic competition and rating agency discipline.

In any event, to the extent that the Agencies nevertheless decide to impose some additional Tier 1 capital limitation on the amount of retained residual interests, we believe that any such requirement should desegregate those interests from other servicing assets and purchased credit card relationships.

C. Potential Alternative Approach

If, notwithstanding the Association's recommendations, the Agencies nevertheless apply new capital requirements to retained residual interests (whether any such new rules are applied only to individual institutions based on the exercise of supervisory discretion by the Agencies, as the Association would prefer, or more universally), we believe that any additional capital requirement that is imposed should be limited to the amount needed to address any increased credit risk exposure occasioned by the securitization transaction, in comparison with the amount of capital that would have been required had the assets remained on an organization's balance sheet.

In this regard the Association generally endorses the alternative approach that we understand has been suggested to the Agencies by a group of commenting banks, including several members of the Association. As we understand this approach, the required regulatory capital relating to a residual interest would not exceed the sum of (a) the amount of capital that would be required if the transferred assets remained on balance sheet, and (b) the incremental amount of capital that relates to any "gain on sale" amount resulting from the transaction.

The Association believes that this formulation would isolate reasonably the source of any incremental credit risk associated with a securitization. In doing so, we believe that this approach responds to the Agencies' policy interest in linking regulatory capital requirements more closely with actual credit risk. It would also avoid the creation of inappropriate economic disincentives to the amount and type of debt that bank issuers may choose to raise via securitization transactions, as part of their overall funding strategy.

D. Grandfathering and Transitional Provisions

In the event that the Agencies decide to adopt any version of these proposals that would have the effect of increasing capital requirements on at least some retained residual interests, the Association recommends that grandfathering and other appropriate transitional

provisions be enacted to avoid dislocations that would be occasioned by the immediate application of these new rules to existing residual interest positions. The immediate effectiveness of these rules could cause certain institutions to experience a regulatory capital deficit, and might therefore cause an inefficient and disorderly restructuring and divestiture of residual interests under distress conditions. We believe that such dislocations would be undesirable from the standpoint of both regulators and regulated institutions.

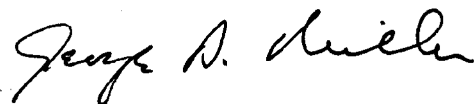
In this context we note that the Agencies' pending proposals concerning recourse arrangements and direct credit substitutes[7] implicitly recognize these potential risks. In particular, those proposals would be applicable only to securitization activities entered into or acquired after the effective date of any final rules, to the extent that those rules would result in increased risk-based capital requirements for banking organizations. The Agencies also propose to allow banking organizations additional time (up to two years after the effective date) to adapt to any new capital requirements for asset securitizations having no fixed term (e.g., asset-backed commercial paper conduits). The Association urges the Agencies to give similar regard to such grandfathering and transitional provisions as may be necessary to assure a smooth transition to any new residual interest capital regulations.

IV. Conclusion

The Association appreciates the opportunity to comment on these proposals. In particular, the Association would be willing to work with the Agencies to develop objective criteria that could be used to distinguish among institutions for the purpose of determining whether appropriate residual interest valuation and risk management methodologies are in place, and thus whether extraordinary capital charges are warranted. We would be equally willing to assist the Agencies in exploring whether benchmark or comparative indicators might be established for assessing the risk profile, and corresponding capital treatment, of specific types or categories of assets and related residual interests. We believe that a narrower and more focused approach along these lines would be more effective and less harmful (to individual institutions and to the securitization market as a whole) than the broader approach suggested by the Agencies.

Thank you for your consideration. Should you have any questions or desire additional information, please do not hesitate to contact the undersigned at 212.440.9403

Sincerely,



George P. Miller
Senior Vice President,
Deputy General Counsel

[7] See footnote 4 above.