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

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

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

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: *Residual Interests in Securitizations*

Ladies and Gentlemen:

I would like to thank the member agencies of the Federal Financial Institutions Examination Council for the opportunity to comment on the September 27, 2000 Notice of Proposed Rulemaking relating to residual interests in securitizations.

The proposed rule would require dollar-for-dollar capital support for retained interests in a bank's own securitizations. The existing capital rule for retained interests in securitizations calls for dollar for dollar capital up to a maximum of 8 percent of the securitization supported by the retained interest. The proposal calls for dollar for dollar capital support with no maximum. If I understand the proposal correctly, a bank retaining a large interest in its own securitization would be required to have more capital than a bank that elects to hold the loans on its books.

The proposal would also include residual interests in two existing deductions of servicing assets in calculating Tier 1 capital for leverage and risk-based capital purposes. Specifically: a deduction would be made to the extent that the sum of mortgage servicing assets, purchased credit card relationships (PCCRs), non-mortgage servicing assets and residual interests exceed 100% of Tier 1 capital; and a second deduction would be made to the extent

that the sum of PCCRs, non- mortgage servicing assets and residual interests exceed 25% of Tier 1 capital.

As the rule is presently written, both the dollar for dollar capital requirement and the various limitations would apply retroactively to existing retained interests and servicing relationships.

Unintended Consequences

If the proposed rule becomes final in its present form, minority and small business lending by banks will be reduced, and all but the largest banks will curtail their securitization activities and perhaps get out of securitization rather than pay the added costs imposed by the proposal. In the end, more credit business will be taken away from well-managed banks and the types of bankers causing the regulators problems will quickly find ways to circumvent the rules. In addition, by limiting bank access to the liquidity provided by securitization and the earnings derived from servicing the regulators will weaken the banking system.

The banks that will be hit the hardest by the proposal will be subprime and high loan to value (LTV) mortgage lenders, and small business lenders who make use of securitization.

Subprime and Minority Lending

The subprime market is larger today than any time since the 1930s and a large percentage of the subprime borrowers are minorities. In fact, a recent study released by the Association of Community Organizations for Reform Now (better known as ACORN) concluded that during the period 1995 to 1998 subprime loans made up 97% of the of the growth in conventional purchase mortgages to African-Americans and 45% of the increase to Latinos.

Over the last two decades the regulators have pressured the banks to meet the credit needs of minority borrowers. Over this same period of time, the regulators have urged banks to price their loans to reflect the underlying risks. Bank subprime lenders are meeting the credit demand of minority borrowers and pricing their risks in a competitive marketplace. As the regulators make it more difficult for responsible banks to accommodate minority borrowers, competition in subprime lending will be reduced, the cost of credit to minority borrowers will go up, and unregulated predatory lenders will be left with a larger share of the market.

If the regulatory agencies are sincere in their attempts to encourage banks to increase minority lending I suggest they exempt residuals and servicing associated with mortgage loans to minorities from the proposed regulation.

High LTV Lending, Taxes and Section 304 of the FDIC Improvement Act

Banks engaged in high LTV lending are also meeting a legitimate credit demand from borrowers who seek lower cost, lower monthly payment, debt consolidation loans and/or the tax advantages associated residential mortgage borrowings.

Aggregate bank holdings of high LTV mortgages are already limited to 100 percent of capital by rules each bank regulatory agency wrote under Section 304 of the FDIC Improvement Act of 1991. Overall, the regulators appear to see high LTV lending as fundamentally flawed. The rules limiting bank holdings of high LTV mortgages were written, and the regulatory attitudes toward high LTV mortgage lending were formed during the real estate/banking crises of the second half of the 1980s and early 1990s. Since then changes in the tax code have made high LTV mortgage borrowing considerably more attractive to consumers because the interest paid on residential mortgage loans is the principal form of interest paid on consumer debt that is still deductible from taxable income. Not surprisingly, borrowers would rather pay 8 or 9 percent (after taxes) on a high LTV home equity loan than 18 percent on a credit card. It is, however, surprising to me that the regulators still have rules in place that limit the availability of high LTV credit to prime borrowers and are proposing additional rules that will further limit the availability of high LTV mortgage credit regardless of the quality of the borrowers.

The tax and cost incentives associated with high LTV mortgages will assure a continuing consumer demand for this type of credit and the increased regulatory burden imposed by the proposal will assure that banks will be less able to meet this demand. The proposed increase in the regulatory burden will deprive well-managed banks of earnings opportunities and probably increase the cost of credit to consumers.

Small Business Lending
Section 208 of the Riegle Community Development and Regulatory Improvement Act (the Riegle Act) directs the bank regulators to permit well-capitalized banks to securitize a limited amount of loans to small businesses, retain recourse, and not have to provide capital for the recourse obligations. The proposed rule's requirements effectively repeal the special exemption the legislation created for small business loan securitizations.

The statutory exemption for small business loans sold with recourse was passed at a time when the bank regulators were harshly criticized for pursuing supervisory policies that restricted credit availability to small business borrowers. In the present case, a failure to exempt small business loan securitization residuals and non-mortgage servicing assets involving small business loans from the proposed rule's requirements will certainly restrict credit to small business borrowers.

It is worth noting that most of the small business loans associated with securitization residuals and/or retained servicing are variable rate loans and often have prepayment penalties and are therefor less inclined to prepay and erode the value of residuals or servicing assets. It is also worth noting that many of the small business loans that are securitized or sold as whole loans were made under various federal guaranty programs. Each of these guaranty programs was established as part of a U.S. government policy designed to promote some aspect of small business lending. In each of these programs the guarantying federal agency closely monitors the performance of the loans made by a particular lender. Indeed the Small Business Administration (SBA) will suspend the lending

authority of a securitizer when delinquencies show an incremental increase. SBA also requires a securitizer to retain a subordinated interest in each securitization of SBA loans. All of the guarantying agencies encourage the originating bank lender to retain servicing on securitized or sold loans.

The residuals associated with any loan that qualifies as a loan to a small business under Section 208 of the Riegle Act should be exempt from the proposed rule's capital requirements, provided all the qualifications, conditions and limitations of Section 208 are satisfied. Additionally, the residuals and servicing assets associated with small business loans that are made under a federal guaranty program should be completely exempt from all of the requirements of the proposed rule.

Outdated Regulatory Thinking Will Weaken the Banking System

By limiting bank access to the funding, earnings and diversification opportunities securitization makes available to small and medium sized banks the regulators are depriving them of the ability to use all the available tools to compete in today's marketplace. As the regulators make it more difficult for all but the largest banks to directly access the securitization markets the regulators are limiting the banks' survival options.

The fundamental unfairness of the current risk based capital system has provided banks with a strong incentive to securitize assets. Now at a time when regulators worldwide are proposing to introduce new elements of fairness into the risk based capital scheme the U. S. bank regulators have proposed the same old, already discredited, one size fits all regulatory approach for securitization. Any reasonable person would have to ask why the regulators are proposing to punish all the banks are because mismanagement and fraud led to high loss rates in three failed banks. This is bad regulation.

Recommendations

My recommendation to the regulators is to do the job of a supervisor. Forget the proposed rule and enforce the safety and soundness standards you already have. A series of recent enforcement actions clearly demonstrate the bank regulators have the ability to use their examination powers to ensure bank securitizers behave in a manner that does not threaten FDIC's insurance fund.

If, despite all of the compelling arguments to the contrary, the agencies are determined to adopt this regulation, all residuals and servicing assets held by banks at the time the rule was proposed should be exempt from the rule's provisions.

Owen Carney
President
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