

December 22, 2000

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 Revisions to Capital Rules-Retained Interests**

The Financial Institutions Accounting Committee (FIAC) appreciates the opportunity to present its comments on the above-referenced joint agency proposal. FIAC is a group of 16 financial professionals working in executive level positions in the thrift and banking industries and is affiliated with the Financial Managers Society.

FIAC's primary responsibility is to evaluate those regulatory matters that affect financial institutions. The comments within this letter are representative of FIAC as a whole and do not necessarily reflect the view of the individual institutions represented on the committee.

The proposal would amend leverage and risk-based capital requirements by requiring "dollar-for-dollar" risk-based capital be held against residual interests from securitization activities and would place a limit on the amount of such residual interests permitted to be included as Tier 1 capital. The proposal specifically requests comments on the proposed "dollar-for-dollar" capital charge, the proposed 25 percent of Tier 1 capital limitation, and the proposed net-of-tax approach to determining the capital charge.

FIAC opposes the inclusion of an additional Tier 1 capital limitation for residual interests, and we believe the increased "dollar-for-dollar" capital charge will result in an excessive capital charge for this type of activity relative to the treatment of other types of assets. We agree with the proposal to assess the capital charge and the limitation on a net-of tax basis, and we believe this net-of-tax treatment should be expanded beyond recorded deferred tax liabilities. Following are our specific comments.

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## *I. The Tier 1 Capital Deduction*

The proposal would require including residual interests within the 25 percent of Tier 1 capital sub-limit already placed on non-mortgage servicing assets and PCCR's. We believe this limitation is inappropriate and that the need for any limitation on these assets is better measured and assessed based upon the agency review of the valuation tools and internal controls established around the business activities resulting in the recording of the retained interests.

A limitation, if necessary, could be assessed during the examination process based upon a review of the controls and processes in place at each institution. A 25 percent limitation will prove to be restrictive when applied to well-managed institutions having a high degree of control over their valuation of these assets and the conduct of the related businesses.

We also contend that this limitation, combined with the "dollar-for-dollar" capital requirement included in the proposal, would result in a required capital level that would exceed the total maximum loss associated with these assets. This combination of the two proposed capital charges is excessive, providing more than 100 percent protection to the banking system for a 100 percent loss on these assets. This requirement runs counter to the basic goals of capital regulations and would make the related business activities unaffordable for many financial institutions.

## *II. The Dollar-for-Dollar Capital Charge*

By requiring dollar-for-dollar capital to be held against residual interests, the agencies would be requiring higher capital than would be required if the assets remained on the balance sheet of the originating institution. The result will be an increased capital charge when the risk-profile of the securitizing institution has improved as the result of the transaction. Under the proposal, the capital required to be held against residual interests resulting from a securitization would amount to the percentage recourse held against the assets sold, rather than the minimal capital requirement (8 percent) against the assets sold. If an entity sells \$100 million of 100 percent risk-weighted assets with 20 percent recourse retained in the form of a residual interest, they would be required to hold \$20 million of capital against those assets. If those same assets were retained on the balance sheet of the originating company, \$8 million of capital would be required.

It is important to consider that by securitizing and selling the assets with the retention of some amount of recourse, the originating company has reduced, rather than increased, their risk associated with the assets originated in the securitization transaction.

The securitization market has grown significantly over the past few years because it provides entities with some significant economic benefits. The completion of the securitization enables the originator to transfer a large percentage of the risk associated with the assets; it enables the entity to fund the assets in its most cost-effective manner by generating collateralized funding of the pooled assets; and it enables the issuer to effectively manage interest-rate risk by matching the term of the borrowing with the terms of the funded assets.

We recognize that often the originator retains a first-loss risk which represents a substantial amount of the risk associated with the transferred assets, however, there is some risk reduction associated with transferring the remaining second-loss to the securities holders. The sale with recourse provisions in the current capital rules will continue to require treating the sold assets as if they remained on-balance sheet for capital purposes. We believe this provides an adequate level of capital protection. This transfer of risk along with the funding and interest-rate gap management advantages achieved through securitizations, and the retention of capital under the sale with recourse provisions will all combine to strengthen the financial position of the originator. However, the proposal would penalize the issuer for this activity by increasing the capital charge associated with securitizations.

Additionally, the proposal would mitigate the provisions of GAAP as applied under SFAS 125, SFAS 140 and related interpretations. We believe attempts to mitigate the application of GAAP by changing regulatory capital requirements is miss-directed. We are concerned with any new rule making which would circumvent GAAP/RAP conformity by amending the capital rules.

It is important to note that current GAAP does require the periodic valuation of retained interests when the asset is deemed to be permanently impaired. Furthermore, recent changes to GAAP will preclude the possibility that the recognition of some reductions in value will be deferred. Under EITF 99-20 (effective for quarters beginning after March 15, 2001), the deferral of the recognition of the impairment would not be permitted and the retained interests would be written down when the fair value (based on the holders best estimate of cash flows) declines below its carrying amount. The valuation requirements and controls established under GAAP do provide for the necessary revaluation of these assets and ensure that capital accounts will regularly reflect the true value of these assets

### *III. Net-of -Tax Adjustments*

We agree that any dollar-for-dollar capital requirement or any limitation established for residual interests should be based on the asset value net of any related deferred tax liability. It is appropriate to tax-effect the capital adjustment, as any write-down of the residual assets would result in a reduction to the deferred tax liability. The reduction to capital of a loss in value will, therefore, be net of the tax impact, and this net economic impact should be reflected in the capital requirements. The economics clearly justify this approach and the complexity associated with this adjustment should not preclude this approach.

Furthermore, we believe the agencies should expand this net of tax treatment to consider not only deferred tax liabilities, but also the tax impact of any potential residual asset write-down. The net-of-tax treatment of the capital adjustment should be expanded to cover the extent an institution's income tax liability in the future will be reduced if it fails to recognize the value inherent in the current valuation of the residual. If the value of the residual were impaired, the impact on net income (and capital) would be net of the corresponding income tax benefit. The recorded income tax benefit would take the form of either a current tax receivable or a deferred tax asset. While the recognition of the current tax receivable would not be a question and should be recognized directly in the capital calculations, the recognition of a notional deferred tax asset would need to be included and subject to the same limitations as currently exist under capital regulations for total deferred tax assets.

IV. *Summary and Conclusions*

FIAC disagrees with the proposal to require additional capital for the holding of residual interests and believes the establishment of a Tier 1 capital limitation is not necessary. If the agencies do move forward with such requirements, the rules should include an expanded net-of-tax concept as previously described. In addition, if rule changes are established, we strongly believe that any residual interests recorded prior to the adoption of final rules should be grandfathered.

FIAC appreciates the opportunity to comment on this proposal, and our members would be happy to discuss these issues further with you and your staff.

Sincerely,



William C. Nunan  
Chairman

cc: Zane Blackburn, Office of Comptroller of the Currency  
Gerald Edwards, Federal Reserve System  
Timothy Stier, Office of Thrift Supervision  
Robert Storch, Federal Deposit Insurance Corporation  
Jeff Mahoney, Financial Accounting Standards Board