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December 22, 2000

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Executive Secretary
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Re: Capital Adequacy Guidelines: Residual Interests in Asset Securitizations or Other Transfers of Financial Assets; FRB Docket No. R-1080; FDIC 12 CFR Part 325; OCC Docket No. 00-17; OTS Docket No. 2000-70

The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (the "Agencies") propose to amend their capital adequacy standards for banks, bank holding companies and savings associations ("banking organizations") concerning the treatment of certain residual interests in asset securitizations or other transfers of financial assets. Residual interests are defined as those on-balance sheet assets that represent interests (including beneficial interests) in the transferred financial assets retained by a seller (or transferor) after a securitization or other transfer of financial assets; and are structured to absorb more than a *pro rata* share of credit loss related to the transferred assets through subordination provisions or other credit enhancement techniques (credit enhancement). The American Bankers Association ("ABA") brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional and money center banks and bank holding companies, as well as savings associations, trust companies and savings banking organizations – makes ABA the largest banking organization trade association in the country.

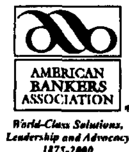
In brief, the Agencies' proposed rule would require that risk-based capital be held in an amount equal to the amount of the residual interest that is retained on the balance sheet by a banking organization in a securitization or other transfer of financial assets, even if the capital charge exceeds the full risk-based capital charge typically held against the transferred assets (the "dollar-for-dollar capital requirement"). The proposed rule also would restrict excessive concentrations in residual interests by limiting the amount that may be included in Tier 1 capital for both leverage and risk-based capital purposes. When aggregated with nonmortgage servicing assets and purchased credit card relationships ("PCCRs"), the balance sheet amount of residual interests would be limited to 25 percent of Tier 1 capital, with any amount in excess of this limitation deducted in determining the amount of a banking organization's Tier 1 capital. Additionally, the maximum allowable amount of mortgage servicing assets, PCCRs, nonmortgage servicing assets, and residual interests, in the aggregate, would be limited to 100 percent of the amount of Tier 1 capital that exists before the deduction of any disallowed mortgage servicing assets, any disallowed PCCRs, any disallowed nonmortgage servicing assets, any disallowed residual interests, and any disallowed deferred tax assets (the "Tier 1 reductions").

General Comments

ABA recognizes that the Agencies have three 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 residual interests; and (3) excessive concentrations of residual interests in relation to capital. While the ABA believes that the Agencies should pursue regulatory and supervisory initiatives to address instances of these concerns, ABA believes that the proposal is overly broad and inconsistent with other pending risk-based capital proposals. ABA believes that the proposed capital treatment of certain residual interests in asset securitizations or other transfers of financial assets should be narrowed and made more adaptable to a case-by-case supervisory approach. Additionally, ABA urges the Agencies to grandfather existing residual interests so as to not disrupt the current securitization market.

ABA encourages the Agencies to adopt a more case-by-case supervisory approach as there are significant differences in risk management and control of residuals among banking organizations. ABA believes that the approach set forth in the proposed capital guidelines fails to give appropriate credit to those banking organizations that are doing a thorough job in such management and control. ABA further believes that this approach is contrary to the general direction that the Agencies are moving in future risk-based capital adequacy revisions, as indicated by the March 2000 proposal on the risk-based capital treatment of recourse and direct credit substitutes (65 Federal Register 12320).

The recourse proposal will significantly change the securitization calculation for banking organizations and enable them to make issuance decisions on more purely economic grounds. That proposal would significantly reduce the capital requirements associated with a retained subordinated interest that received a rating in the BB category or higher from a nationally recognized statistical



rating organization. As the Agencies have acknowledged, the September residual interest proposal conflicts with that earlier proposal in that, among other things, the residual interest proposal does not differentiate among residual interests based upon their relative credit quality. Because of this conflict, ABA believes that the residual interest proposal should not be adopted in its current overly broad formulation.

Specific Recommendations

The Dollar-for-Dollar Capital Requirement

Institutions that have invested the time and resources to develop good risk management controls should not be subject to incremental capital requirements inspired by one or two extraordinary situations. Instead ABA supports a regulatory response that relies upon existing regulatory authority to impose additional capital requirements in appropriate situations. Existing and proposed banking organization regulations include numerous precedents for treating banking organizations differently, depending upon their complexity, size and other factors. This is consistent with the general movement away from "one size fits all" regulations to more market driven regulatory approaches. In fact, the Agencies have exercised existing authority to specifically regulate valuations of residual interests, for instance by stipulating the valuation assumptions that were to be used in calculations of residuals or limiting a banking organization's growth or holdings in a particular asset category.

ABA recommends that the Agencies rely upon a case-by-case supervisory approach, combined with enhanced disclosures that will already be required under SFAS 140 (see below). Banking organizations would continue to operate under the current capital rules except where examiners identified a problem situation. Then additional capital would be required, based upon a modified version of the dollar-for-dollar capital requirement.

An alternative approach would be to make the dollar-for-dollar capital requirement apply to all banking organizations, except banking organizations that have qualified to use the current low level recourse and other capital rules through a regulatory approval process. Such an approval process would require that the terms of qualification were reasonable, reflecting the banking organization's real expertise and credibility in valuing and managing its risks, and the expanded dollar-for-dollar requirement would not take effect until banking organizations had been given time to qualify for the alternative treatment.

If the Agencies persist in the belief that a one-size-fits-all regulation is necessary, then ABA recommends that the new rule only require additional capital when the risks inherent in particular residual interests justify it. ABA recommends the following:

1. Adjustment in the Capital Requirement to Reflect High Quality Exposures. In the March Recourse and Direct Credit Substitute proposal, the Agencies proposed to apply risk weighting to rated positions, including residuals, so that residuals rated AAA or AA would have been risk weighted

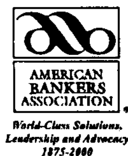
20%, rated A would be 50%, BBB would be 100%, and one category below investment grade would have been risk-weighted at 200%. Lower or unrated assets would have been subject to the "gross-up" treatment in the proposal.

The March proposal reflects years of study by the Agencies and several rounds of input from affected institutions and other constituencies. It is also consistent with recent international proposals to base bank regulatory capital requirements on external or internal credit ratings on banking assets. ABA believes that the approach taken in the recourse proposal should be continued in this proposal. The recourse proposal also suggested limited use of approved internal bank rating systems for some capital-related purposes. Banking organizations with internal rating systems that are satisfactory to their primary regulator should be permitted to use ratings under those systems to avoid these new capital requirements for residual interests that are rated high enough. ABA has supported that approach in other recent risk-based capital proposals of the Agencies and recommends that the Agencies use that same approach for residual interests.

One good reason for excluding appropriately rated positions from the dollar-for-dollar capital requirement is that it enables banking organizations to make funding decisions more on cost of funding and other economic bases, without any bias from cliff effects in regulatory capital requirements. From the point of view of this particular goal, it would primarily be subordinated securities representing a portion of the principal amount of the transferred assets that would be most likely to be rated and to avoid an incremental capital requirement. That type of residual interest is obviously amenable to the methodologies that an external rating agency or internal banking organization system would use, since this type of interest is commonly sold to third party investors on the strength of external ratings.

Interest-only strips and other assets created through the transfer process should also not be subject to incremental capital requirements if they receive high enough external or internal ratings, so long as those ratings clearly address the certainty of receipt of a stated amount of payments. Although an interest-only strip or similar asset may be valued based on a set of subjective assumptions, those assumptions would have to be stress tested to a high level of confidence to obtain a rating of the type referred to above on all or some portion of that type of residual interest. If the Agencies are concerned about the use of internal ratings of interest-only strips or similar assets, the Agencies could mandate special regulatory approval of the internal rating system of any banking organization that wishes to use its system to reduce the capital required for these types of assets.

2. "Gain on Sale" Assets. The dollar-for-dollar capital requirement could increase the capital requirement for a residual interest above the capital requirement for the transferred assets when they were held on the banking organization's balance sheet. This perverse result could only be justified (a) if the securitization is viewed as having provided previously unavailable evidence that the transferred assets are exceptionally risky, so that the extra capital would have been appropriate at all times, or (b) if the banking organization's balance sheet is exposed to more credit risk after the securitization than it was before the securitization.

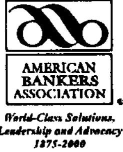


ABA does not believe that the Agencies should presume that a large residual interest indicates particularly risky underlying assets. There are a variety of reasons other than asset quality that may lead a banking organization to retain a large residual interest. These include cost of funding considerations, low risk weighting of the underlying assets and securitization structure, such as conduit transactions. If the Agencies believe that some asset types need more than the normal capital support, then the Agencies should address these asset categories on a uniform basis rather than focus solely on pools that have been securitized in off-balance sheet transactions. Otherwise, this would create artificial incentives against off-balance sheet securitizations. If a banking organization's capital requirements were going to be increased by executing a transaction in which assets would be derecognized, it could avoid that result by instead completing a comparable on-balance sheet transaction. As a result, this change would not be an effective deterrent for any institution that was seeking excessive leverage against capital. Its primary effect would instead be to create artificial capital constraints for legitimate derecognition transactions that happen, for one of the reasons mentioned above, to include relatively large aggregate residual interests.

As to situations when the banking organization's balance sheet is exposed to more credit risk after the securitization than it was before the securitization, incremental risk for a banking organization can only happen as a result of (and to the extent that) the securitization creates an interest-only strip or other new asset that is recognized on the banking organization's balance sheet. Assets created in this way may be termed "gain on sale assets." If the only possible source of incremental credit risk to a banking organization is the creation of gain on sale assets, then incremental capital should only be required for gain on sale assets. Specifically, ABA recommends that the required capital relating to a residual interest should never exceed the sum of (a) the amount of capital that would be required if the transferred assets were held on-balance sheet and (b) incremental capital relating to the gain on sale amount. This sum would be a maximum. If the amount of the residual interest were less than the maximum, then the required capital would equal the amount of the residual interest, consistent with the existing low level recourse rules. The capital requirement would change over time as the transferred assets liquidate or as collections are reinvested during a revolving period and to reflect changes in the valuation of the gain on sale assets.

The gain on sale amount would be used to calculate the banking organization's capital requirements as of the end of the period in which the transfer occurred. In each subsequent period, the remaining gain on sale amount would be revalued, and the new value would be used to calculate the banking organization's capital requirements. Since the gain on sale amount does not precisely correspond to any balance sheet asset, some method would have to be devised to track its remaining balance over time. Each banking organization should be permitted to choose a reasonable method that approximates GAAP.

3. Additional adjustments needed due to other risk-based capital provision. For banking organizations that qualify to use the Agencies' market value capital rules for their trading account, the Agencies should clarify that the dollar-for-dollar capital requirement applies only to assets that are held in a banking organization's lending account. Assets held in the trading account are dealt with



under the market risk rules, which already require prudent capital for those assets. Also the dollar-for-dollar capital requirement should only apply to the transferring banking organization and should not apply at the consolidated holding company level.

The Tier 1 Deductions

The Tier 1 deductions would directly affect a number of banking organizations, even where the banking organization's aggregate residual interests, considered alone, do not approach 25% (let alone 100%) of the banking organization's Tier I capital. In particular, due to the significant consolidation in the credit card business through portfolio purchases, some banking organizations have built up substantial PCCRs. Under the proposal, a banking organization could face incremental capital requirements if the sum of its PCCRs together with other specified assets is close to, at or above the 25% or 100% limitations, as applicable, even if residual interests by themselves do not make up a material portion of the banking organization's capital.

Thus, ABA opposes adding residual interests to the 100% limitation on the amount of servicing-type assets that may be counted towards Tier 1 capital and to the 25% sub-limit for non-mortgage servicing assets. The existing sales with recourse rules, as supplemented by the dollar-for-dollar capital requirement included in the proposal, require banking organizations to hold extraordinarily high levels of capital against residual interests. Adding residual interests to the 100% and 25% Tier 1 deductions would inappropriately duplicate these already conservative requirements.

In fact, it could have the effect of requiring banking organizations to hold capital in excess of their maximum recourse exposures. The dollar-for-dollar capital requirement will require capital coverage for 100% of a banking organization's exposure in all cases (if the proposal is adopted as proposed) or many cases (if the proposal is modified as ABA suggests). Therefore, any incremental capital required by the Tier 1 deductions will be in excess of 100% coverage. It is hard to imagine the justification for this. No matter how risky the Agencies think some residual interests may be, it is hard for these assets to cause losses to a banking organization's capital in excess of their balance sheet carrying values.

This is not the first time that the Agencies have considered including residual interests in the Tier 1 deductions for servicing assets. In August 1998, the Agencies increased from 50% to 100% the amount of servicing assets that can be included in Tier 1 capital. At that time, the Agencies specifically considered the application of the Tier 1 deductions to interest-only strips receivable–the most common form of residual interest. At that time, the Agencies appropriately decided not to include interest-only strips in these calculations. Among other reasons, the Agencies cited comments noting that two other features of the capital regulations already deal with these assets:

> "banking organizations' interest rate risk models currently measure and assess the risk of I/O strips, which provide a better analytical foundation for establishing capital requirements than imposing rigid percentage-of-capital limitations. Other commenters

> stated that I/O strips receivable often serve as a credit enhancement to securities holders and therefore already are subject to the capital treatment for recourse obligations and direct credit substitutes."[1]

ABA believes that the Agencies made the right decision at that time with regard to the Tier 1 deductions as an alternative to recourse treatment rather than something that should be applied in a duplicative manner to an asset type that is already covered by the recourse rule. ABA recommends that the Agencies continue that approach now, as the same rationale continues to apply.

In discussing that prior decision in the current proposal, the Agencies refer to two changes since the time of the prior decision:

> "a trend toward the securitization of higher risk loans has now resulted in residual interests that exceed the full capital charge and for which "dollar-for-dollar" capital is not required under the current risk-based capital rules."
>
> "This trend has also resulted in certain banking organizations engaged in such securitization transactions having large concentrations in residual interests as a percentage of capital."[2]

As to the first of these points, it is true that under current rules a very large residual interest can exceed the related capital requirement, since the dollar-for-dollar capital requirement is capped at the full on-balance sheet capital charge. However, the expanded dollar-for-dollar capital requirement called for by the proposal will change that. Even with the changes requested, a dollar-for-dollar capital requirement would apply to all residual interests for which extraordinary capital requirements are justified. As a result, including residual interests in the 100% and 25% limit calculations would once again require duplicative capital.

As to the second point, no matter how concentrated a banking organization's assets may be in this area, it is hard to see a rationale for requiring banking organizations to hold more than 100% capital against these assets. That would be the result of both expanding the dollar-for-dollar capital requirement and adding residual interests to the Tier 1 deductions.

If the Agencies nevertheless decide to change the current approach and impose these duplicative requirements, ABA requests that, at a minimum, the Agencies raise the applicable percentage thresholds for the deductions. The August 1998 increase in the overall servicing asset threshold from 50% to 100% was made in recognition of accounting changes that had increased the categories of assets that were subject to the overall limit. Similarly, ABA suggests that the Agencies increase the 25% and 100% thresholds to 50% and 150%, respectively, to accommodate the addition of a new asset type to the categories that are subject to those limits.

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[1] 63 Fed. Reg. 42667, 42672 (August 10, 1998).
[2] 65 Fed. Reg. 57996-7.

Furthermore, if any residual interests are going to be included in calculation of the Tier 1 deductions, it should only be interest-only strips receivables. Retained subordinated interests that represent a portion of the principal balance of transferred assets are very different from the servicing assets and PCCRs otherwise included in the deduction. To the extent that a servicing asset could itself ever be a residual interest, it would already be counted as a servicing asset in calculating the Tier 1 deductions.

Finally, if the Agencies decide to add residual interests to the Tier 1 deductions or separately limit these assets, either in lieu of or in addition to, adopting the dollar-for-dollar capital requirement, then the limitations that we requested above with respect to the dollar-for-dollar capital requirement should instead apply to the Tier 1 deductions. Specifically:

- Residual interests that achieve external or qualifying internal ratings high enough to avoid gross up treatment should not count in calculating the Tier 1 deductions.

- Only the "gain on sale amount," calculated as described above, should be counted towards the Tier 1 deductions.

Additional Complementary Recommendations

Net-of-Tax Calculations. The Agencies propose to continue to apply the capital requirements for residual interests on a net-of-tax basis. ABA recommends that that treatment should be expanded in one respect. Currently, an interest-only strip receivable is effectively "linked" to the related change in the banking organization's deferred tax position. This is not a situation where the interest-only strip receivable could be written off, but the banking organization would still owe the corresponding deferred taxes. To the extent that an asset of this type is written off as a result of actual losses on the underlying receivables exceeding the losses assumed for purposes of calculating the amount of the asset, there should be a corresponding reduction in the banking organization's tax liabilities. To the extent that any of the Agencies do not currently permit this netting, conforming changes should be made to bring that agency's rules in line with those of the Agencies that do permit it.

Most mortgage securitization transactions have to be structured as REMICs for tax purposes. REMICs are, by definition, treated as sales for tax purposes to the extent that the regular and/or "residual interests" (in the defined REMIC meaning) are sold. Accordingly, taxable gains on sale are recognized immediately. To provide consistency of capital treatment between these transactions and transactions that are treated as debt for tax purposes, we propose that the practice of netting associated taxes should be expanded to cover associated income taxes that have been paid, to the extent that an institution's net income tax liability in the future will be reduced (or refund increased) if the ultimate collections on the residual interest are less than was anticipated in determining the taxes that were previously paid.

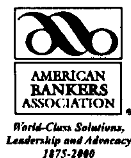
Definition of "Residual Interest." Besides the substantive changes to the definition of "residual interest" recommended above, ABA believes the listing of typical examples in the proposed definition needs to be made subject to the substantive conditions of the rest of the definition. That is, ABA believes that the Agencies intend that an interest-only strip receivable only be included as a residual interest if it absorbs more than a *pro rata* share of credit risk. However, the actual language of each Agencies' proposed regulation actually differs from each other somewhat, creating some confusion. ABA requests that each of the Agencies make it very clear that none of these types of assets is to be treated as a residual interest unless it is structured to absorb more than a *pro rata* share of credit risk.

Additional Call Report Disclosures. In a May 25, 2000 letter, the Board of Governors of the Federal Reserve System provided comments to the Financial Accounting Standards Board on the FASB's preliminary views publication on Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value. In that letter, the Federal Reserve Board noted that "Disclosure . . . can be a useful venue for a firm to discuss the fair value of its intangibles, the impact of its credit standing, and other issues that present significant hurdles to incorporation in the primary financial statements." ABA supports the Federal Reserve Board's position that analytical disclosures are an appropriate way to deal with these types of valuation concerns and believes that the recently adopted SFAS 140 will fully address this need. These new annual disclosures (which become effective for calendar years ended December 31, 2000) will require very detailed information about the nature of retained interests, valuation assumptions, sensitivity tests, and cash flows between the banking organization and securitization trusts or other special purpose vehicles.

The ABA further suggests that banking organizations should be given the option to incorporate information from their most current annual audited financial statements with their annual regulatory filings to avoid reporting duplication. Banking organizations with fiscal year-ends for reporting to shareholders should be allowed to use their most recent fiscal-year information in their year-end regulatory filings. The cost-benefit to develop a second set of year-end disclosure requirements would be a significant reporting effort that can not be justified.

The SFAS 140 disclosures are only required annually, but, as with all material GAAP disclosures, they are required to be updated in interim periods if there are material changes in fact or circumstance that might cause the annual disclosures to be misleading. In such a case, updated disclosure information could be included (or incorporated by reference from other interim financial statements such as a Form 10-Q) in the corresponding interim regulatory filing. Requiring significant SFAS 140-type disclosures in interim financial statements would again be a significant reporting effort for all banking organizations, and could for many banking organizations jeopardize the timely filing of their interim reports. ABA strongly believes that the GAAP disclosure and reporting framework will provide the Agencies with adequate information to carry out their regulatory oversight functions.

Grandfathering Finally, ABA recommends that any residual interests arising from transfers completed prior to the adoption of final rules on this subject be grandfathered. These interests may have been structured in ways that lead to exceptional capital requirements but in fact do not bear risks that justify those requirements. Had the banking organizations involved known of these requirements,



they might well have been able to take actions to avoid these results, but they may now be unable to change the terms of these completed transfers. Further, historical information indicates that the majority of retained interests will roll off within the next five years.

Conclusion

The American Bankers Association appreciates the opportunity to comment on the Agencies' proposed risk-based capital treatment of certain residuals. While ABA understands the concerns of the Agencies about the risks of residuals used as credit enhancements, ABA encourages the Agencies to address the concerns of banking organizations in their proposal. The ABA believes that concerns stated by the Agencies will be resolved under pending GAAP pronouncements, making the Agencies' proposal unnecessary. If the Agencies do adopt the proposal, ABA requests that the Agencies avoid penalizing banking organizations that currently manage their securitization process appropriately. Should the staff of the Agencies have any questions about ABA's comments, please call Gwen Ritter, Tax and Accounting Division, or the undersigned.

Sincerely,

Paul A. Smith