1st Financial Bank USA

363 W. Anchor Drive
Dakota Dunes, South Dakota 57049-1050
605-232-3058

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December 22, 2000

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429

Attention: Comments/OES

Re: Docket No. 2000-70; 12 C.F.R. Part 325; 65 Fed. Reg. 57993-58008 (September 27, 2000); Notice of Proposed Rulemaking – Capital; Leverage and Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance; Residual Interests in Asset Securitizations or Other Transfers of Financial Assets

Dear Mr. Feldman:

1st Financial Bank USA (the "Bank") appreciates the opportunity to comment on the Notice of Proposed Rulemaking on Residual Interests in Asset Securitizations or Other Transfers of Financial Assets (the "NPR") issued by the FDIC and the other federal banking agencies and published in the Federal Register on September 27, 2000.

This comment letter addresses the following issues that the Bank believes were raised by the NPR:

1. Existing supervisory guidance issued by the federal banking agencies covers the issues raised in the NPR with respect to residual interests. To the extent the banking agencies identify certain risks with residual interests held on banks' balance sheets, those residual interests may be dealt with on a case by case basis at the supervisory level, as provided in the existing supervisory guidance, and do not require the issuance of a new rule.

2. The NPR singles out residual interests maintained on banks' balance sheets to assign a capital requirement to those interests that would be in addition to, and potentially different from, the capital requirement for residual interests and other recourse obligations in connection with asset securitizations, as proposed in the banking agencies' March 2000 proposed revisions to the risk-based capital treatment of recourse arrangements, direct credit substitutes and

asset securitizations (the "recourse proposal"). The issue of assigning appropriate capital requirements to recourse obligations in securitization transactions has been discussed and revised in prior proposals in the 1990s. The Bank believes that the banking agencies should continue with their established approach of resolving their concerns with residual interests as part of the recourse proposal, rather than as a separate rulemaking.

3. There is an extra regulatory burden associated with having to conform to two rules – the NPR and the recourse proposal if they are finalized – when one rule appears to be sufficient and would avoid the potential for inconsistent treatment between the two rules.

4. Assuming arguendo that a separate rule for residual interests is adopted, then the Bank requests that the banking agencies acknowledge in writing that residual interests subject to the proposal would not include what is commonly known as the transferor's retained interest in assets transferred in an asset securitization.

5. The NPR should be revised to address more specifically the areas of concern cited by the banking agencies in the NPR. To assist the agencies in identifying adequate levels of capital for residual interests, the Bank suggests that the required capital amount for a residual interest should not be greater than the sum of the required capital that would be required had the securitization not occurred, such that the transferred assets continued to be on the balance sheet, and the amount of the new asset (net of tax) that is booked on the bank's balance sheet as a result of the securitization (*i.e.,* assets booked on the balance sheet using gain on sale accounting). This approach for setting capital levels may result in required capital amounts that are less than the capital amounts that would be required under the agencies' "dollar-for-dollar" method in the NPR. Nevertheless, if the agencies are proposing the "dollar-for-dollar" method because they are concerned with residual interests generated from the securitization of what they consider to be low quality or high loan-to-value loans, then the agencies should define in the NPR what they mean by "low quality" assets or "high-loan-to value" loans. Otherwise, to apply the "dollar-for-dollar" method to residual interests for all securitized assets produces the unfair and inconsistent result of requiring banks to maintain more capital after a securitization than if those assets had not been securitized. To address the agencies' concerns about the potential volatility of residual interests, the amount that is applied against the concentration limits of residual interests in Tier 1 capital should be the amount of the new asset (net of tax) booked on the balance sheet as a result of the securitization. This amount appears to be appropriate because only those new assets resulting from the securitization are based on a subjective valuation, which could have the volatility cited by the banking agencies.

6. The NPR should be revised to permit any disallowed amounts of residual interests (*i.e.,* those amounts in excess of the 25 percent of the Tier 1 capital sublimit), and any amounts of residual interests that are subject to the dollar-for-dollar capital requirement (*i.e.,* those amounts included in the 25 percent of the Tier 1 capital sublimit) to be determined on a basis that is net of any associated tax effect, instead of specifically limiting the net-of-tax treatment for such interests "on a basis that is net of any associated deferred tax liability" as the NPR presently provides.

Each of these issues is discussed below.

1. Existing published guidance and supervisory oversight by the federal banking agencies are sufficient and give those agencies the leeway to address their concerns with residual interests. The Interagency Guidance on Asset Securitization issued in December 1999, as stated in the NPR, emphasized the banking agencies' concerns with certain residual interests generated from the securitization of assets. The Securitization Guidance provided that bank management should implement policies and procedures to limit the amount of residual interests that may be carried as a percentage of capital. The Securitization Guidance said that the banking agencies wanted the value of a residual interest to be supported by objectively verifiable documentation of the asset's fair market value utilizing reasonable, conservative valuation assumptions, and that residual interests that failed to meet the agencies' expectation in this regard should be classified as "loss" and disallowed as assets of the banking organization for regulatory capital purposes. The Bank agrees with the instruction in the Securitization Guidance that would disallow as bank assets residual interests booked using gain-on-sale accounting that were not valued utilizing reasonable, conservative valuation assumptions, and not count those assets for regulatory capital purposes. The Bank similarly agrees that fair value estimates of residual interests that are based on aggressive assumptions of expected cash flows should keep those residual interests from being included as assets of the bank for regulatory capital purposes. On the other hand, those residual interests that satisfy the "fair value test" as set forth in the Securitization Guidance would not appear to raise the concerns identified by the banking agencies in the NPR.[1] Therefore, the Bank believes that the Securitization Guidance adequately addresses the banking agencies' concerns with respect to risks posed by carrying residual interests on banks' balance sheets. Furthermore, the banking agencies may currently use the examination process to identify and address those residual interests that fail the "fair value" test or otherwise raise the concerns identified by the banking agencies in the NPR, without having to resort to a new rule.

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[1] The banking agencies identified the following "three areas of continuing supervisory concern" in the NPR: "(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." 65 Fed. Reg. 57993, at 57995.

The Bank believes that the following example is helpful in making its point that the Securitization Guidance and the supervisory process already in place are sufficient to address the agencies' concerns with the valuation and concentrations of residual interest. In the example, a bank determines the valuation of its residual interests utilizing valuation assumptions that are reasonable and conservative in everyone's opinion. The valuation assumptions are reviewed for consistency with GAAP by the bank's external auditors, as part of their annual external audit of the bank. In that example, because of the bank's very conservative valuation of its residual interest, it would not appear to be necessary that the bank hold capital "dollar-for-dollar" against the residual interest above the capital charge for any other asset on the bank's balance sheet. Likewise, because of the very conservative valuation of the bank's residual interest, it would not appear that the bank would hold an excessive concentration of residual interests in relation to its capital. On the other hand, for those other banks that aggressively value their residual interests, that valuation would be inconsistent with the Securitization Guidance and may be addressed by the banking agencies on a case by case basis with the individual banks during the examination process. The Bank believes that relying on the Securitization Guidance and the supervisory process is the more preferable way of dealing with the potential overvaluation of residual interests, instead of instituting a new rule that would needlessly affect banks that use conservative valuations for their residual interests and would needlessly hinder their ability to securitize their assets.

In going forward with the Securitization Guidance, instead of adopting the NPR, the banking agencies may want to consider proposing definitions of what would constitute overly aggressive valuations of residual interests under the Securitization Guidance. If a bank's residual interest valuation was too aggressive based upon the definition adopted by the banking agencies, then those residual interests would be disallowed as assets of the banking organization for regulatory capital purposes. That approach would satisfy the agencies' concerns with respect to the valuation and concentrations of residual interests on banks' balance sheets, without disrupting the securitization markets.

2. <u>Capital requirements for residual interests should be dealt with in one rule – the banking agencies' recourse proposal</u>. The NPR singles out residual interests maintained on banks' balance sheets to assign a capital requirement to those interests that would be different from the capital requirement for other similar recourse obligations of the bank. In doing so, the NPR also seeks to impose a new capital requirement rule for residual interests that is different from the approach published for comment by the banking agencies in the recourse proposal. In March 2000, the banking agencies issued the recourse proposal, which is a comprehensive proposal designed to equalize the capital treatment associated with various recourse obligations of banks, including residual interests. Final agency action has not been taken with respect to the

recourse proposal. However, the NPR in singling out residual interests made clear that the banking agencies' current intention is that residual interests would have to comply with the different capital requirements in the NPR and the recourse proposal, if they were finalized. The banking agencies indicated in the NPR that regulatory capital treatment of residual interests resulting from these two proposals would be consistent and invited comment on how to reconcile the differences between the two proposals. The Bank's comment on that issue is that reconciling those differences and running the possible risk of inconsistent treatment in a limited number of cases would not be necessary if the capital requirements for residual interests were determined on the basis of one rule – the recourse proposal as planned by the agencies in March 2000.

3. Avoid extra regulatory burden of complying with two rules. There is an extra regulatory burden associated with having to conform to two rules – the NPR and the recourse proposal if they are finalized. Instead of having to reconcile the capital treatment of residual interests under both proposed rules, the banking agencies could address their concerns with residual interests in the recourse proposal, which would establish the capital requirements for residual interests and the other recourse arrangements. Having capital requirements for recourse arrangements in the recourse rule would be consistent with approach announced with the March release of the recourse proposal to equalize capital charges to be assessed on various recourse arrangements.

4. Definition of residual interests should exclude transferor's retained interest. The NPR defines "residual interests" as balance sheet assets that represent interests in transferred financial assets retained by the transferor (or seller) after a securitization, 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. The NPR next provides that these residual interests are "first-loss" positions that provide credit support for the senior positions of the securitization, and that a key aspect of the residual interests is that they reflect an arrangement in which the transferor retains risk of credit loss in connection with the transfer of assets. The NPR also excludes from the definition of "residual interests" those interests that do not serve as credit enhancements. The Bank requests that if the NPR is adopted, the banking agencies acknowledge in connection with the final rule that the definition of "residual interest" does not include what is commonly known in the securitization industry as the transferor's (or seller's) retained interest in securitized assets. In credit card securitizations, the transferor's retained interest refers to the transferor's interest in the transferred account balances after the transfer. The credit card account balances transferred in a securitization may include principal and finance charges for the transferred accounts. Unlike the residual interests, the transferor's retained interest neither absorbs more than a pro rata share of credit loss nor otherwise serves as credit enhancements in the securitization. In short, the retained interests are not "first-loss" provisions providing credit support to senior positions in a

securitization, but, instead, share in any credit losses pari passu with the senior positions. In connection with acknowledging that the transferor's retained interest is not included in the definition of "residual interest", the banking agencies are also requested to clarify that the reference to the transferor's risk of credit loss in the statement in the NPR that "a key aspect of residual interests is that they reflect an arrangement in which the transferor retains risk of credit loss in connection with the transfer of assets" refers not to the fact that the transferor may suffer a credit loss with respect to securitized assets but only to those situations where the transferor has a "first-loss" position.

5. The NPR should be revised to address more specifically the areas of concern cited by the banking agencies in the NPR. If the NPR were adopted in its current form, banks would be required to hold capital "dollar-for-dollar" against all residual interests on their books generated from the securitization of *any* bank assets. This requirement would apply to the capital treatment of "low-level recourse" obligations and the capital treatment of any assets securitized with recourse in those cases where the amount of the residual interest retained on balance sheet exceeds the full capital charge for the assets transferred, regardless of the quality of the transferred assets. The effect of this "dollar-for-dollar" requirement would be to increase the capital required for a residual interest above the capital required for securitized assets had they been held on the bank's balance sheet. This increase in the capital for residual interests should only be required if the bank is exposed to more credit risk as a result of the securitization than it was before the securitization. That is, as a result of the securitization, a new asset appears on the bank's balance sheet, such as assets booked on the balance sheet using gain on sale accounting. Therefore, if the incremental credit risk to a bank after a securitization is due to the creation of such new assets, then the amount of incremental capital to meet that risk should not exceed the book value of the new asset (net of tax) created as a result of the securitization. Consequently, to assist the agencies in identifying adequate levels of capital for residual interests, the Bank suggests that the required capital amount for a residual interest should not be greater than the sum of the required capital that would be required had the securitization not occurred, and the amount of the new asset (net of tax) that is booked on the bank's balance sheet as a result of the securitization (*e.g.*, assets booked on the balance sheet using gain on sale accounting).

   This approach for setting capital levels may result in required capital amounts that are less than the capital amounts that would be required under the agencies' "dollar-for-dollar" method in the NPR. Nevertheless, if the agencies are proposing the "dollar-for-dollar" method in the NPR because they are concerned with residual interests generated from the securitization of what they consider to be low quality or high loan-to-value loans[2], then before

[2] See, e.g., 65 Fed. Reg. at 57995 (the banking agencies' concerns regarding excessive concentration and adequacy of capital are heightened where the residual interests are generated from the securitization of low-quality or high loan-to-value loans).

promulgating a final rule incorporating that "dollar-for-dollar" method, the agencies should define what they mean by "low quality" assets or "high-loan-to value" loans. Otherwise, to apply the "dollar-for-dollar" method to residual interests for all securitized assets as proposed in the NPR produces the unfair and inconsistent result of requiring banks to maintain more capital after a securitization than would have been required for the securitized assets under the existing capital rules had those assets not been securitized.

To address the agencies' concerns about the potential volatility of residual interests, the amount that is applied against the concentration limits of residual interests in Tier 1 capital should be the amount of the new asset (net of tax) booked on the balance sheet as a result of the securitization. This amount appears to be appropriate because only those new assets resulting from the securitization are based on a subjective valuation, which could have the volatility cited by the banking agencies.

6. <u>The "net of tax treatment" in the NPR should be revised to permit disallowed amounts of residual interests and amounts of residual interests that are subject to the "dollar-for-dollar" capital requirement to be determined on a basis that is net of any associated deferred tax effect, instead of specifically limiting the net of tax treatment to instances where a deferred tax liability exists.</u> With respect to the net of tax treatment for residual interests, the NPR would permit (1) any disallowed amounts of residual interests (<u>i.e.</u>, those amounts in excess of the 25 percent of Tier 1 capital sublimit) and (2) any amounts of residual interests that are subject to the "dollar-for-dollar" capital requirement (<u>i.e.</u>, those amounts included in the 25 percent of Tier 1 capital sublimit) (hereinafter, amounts in 1 and 2 are collectively referred to as "disallowed residual interests) to be determined on a basis that is net of any associated deferred tax liability. The NPR then explicitly provides: "In instances where there is no difference between the book value and the tax basis of the residual interest, no deferred tax liability would be created." This statement in the NPR seems to imply that in order to utilize the net of tax treatment for residual interests, there needs to be a *net* deferred tax liability related to the disallowed residual interest, versus considering the deferred tax effect of excluding the disallowed residual interest from the bank's financial statements. The Bank believes that the better approach to the net of tax treatment for residuals, which should be incorporated into the NPR, is to permit the disallowed interests to be determined on a basis that is net of any associated tax effect, instead of limiting the net of tax treatment to instances where a deferred tax liability exists.

The Bank believes that the benefit of its recommended approach is illustrated by the following two examples[3].

[3] These examples were prepared in consultation with the Bank's outside accounting firm.

Example 1: A bank has a disallowed residual interest of $3,000,000. The disallowed residual interest is based upon the net present value of estimated excess spread from a securitized loan portfolio. In this example the bank has a book basis in the disallowed residual interest of $3,000,000 and a tax basis of zero, creating a net taxable temporary difference of $3,000,000, with an associated deferred tax liability of $1,200,000 (assuming a 40% effective tax rate).

Example 2: A bank has a disallowed residual interest of $3,000,000. The disallowed residual interest is based on the net present value of the estimated realization of an off balance sheet cash collateral account (CCA) of $4,000,000 as well as estimated excess spread from a securitized loan portfolio. Although the CCA is not separately recognized as an asset for book purposes, it has a tax basis of $4,000,000. Therefore, in this example, the bank has a book basis in the disallowed residual interest of $3,000,000 and a tax basis in the CCA of $4,000,000, creating a net deductible temporary difference of $1,000,000, with an associated deferred tax asset of $400,000 (assuming a 40% effective tax rate and no valuation allowance). Further assume that if the residual interest were written off, that the application of generally accepted accounting principles would not require a valuation allowance on the resulting increase in deferred tax assets to $1,600,000 (tax basis in the CCA of $4,000,000 times effective tax rate of 40%).

Under Example 1, the NPR would "disallow" $1,800,000 ($3,000,000 less $1,200,000). Under Example 2, the NPR would appear to "disallow" the full $3,000,000 residual interest.

Under Example 2, the Bank suggests that the NPR should also "disallow" only $1,800,000, on the basis that the net decrease in equity of "writing off" the residual interest would be $1,800,000. The Bank concurs with the NPR that the resulting deferred tax asset of $1,600,000 would be subject to the existing capital limitations set out in 12 CFR 325.5(g).

It seems counterintuitive that a disallowed residual interest that is actually supported by a cash collateral account would require more capital than a disallowed residual interest with the same valuation that is not supported by a cash collateral account.

It seems logical that the net-of-tax basis refers to the potential impact to equity, including the corresponding tax effect, of taking the disallowed residual interest off the bank's books. In both Example 1 and Example 2, if the bank were required to write off the disallowed residual interest, it would indeed get a corresponding tax credit, and thus the reduction to equity would only be the net amount of $1,800,000.

In Example 2, as it relates to the disallowed residual interest, the bank is only at risk for the net amount of $1,800,000. If the disallowed residual interest

and the CCA were both exhausted, the bank would be able to deduct the full $4,000,000 basis in the CCA, and therefore realize the related deferred tax asset of $1,600,000 as a tax refund or reduction in current tax liability.

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On behalf of the Bank, I want to thank you again for the opportunity to provide the Bank's comments on the NPR. If you have any questions concerning the comments made in this letter, please call me (605) 365-5191 or George Seeberger, the Bank's General Counsel, at (203) 662-7509.

Very truly yours,

Scott Scheinost
Senior Vice President

Cc: George Seeberger, Esq.

Communications Division
Third Floor
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Attn: Docket No. R-1080

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