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December 26, 2000

Docket No. R-1080
Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal
Reserve System
20th Street and Constitution Ave., N.W.
Washington, D.C. 20551

Mr. 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
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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:

On behalf of the Management and Board of Directors of First International Bank (the "Bank"), 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 generally would:

- Require banks to hold dollar-for-dollar capital against the amount of residual interests, even if the resulting capital charge exceeds the full on-balance sheet risk-based capital charge typically held against the transferred assets; and

- Include residual interests in two existing deductions of servicing assets in calculating Tier 1 capital for leverage and risk-based capital purposes.

We are concerned that the proposed regulations in their current form would: a) unnecessarily restrict access to capital for small business in every sector of the economy, including small exporters and small businesses located in rural areas, and b) make small banks uncompetitive in small business lending vis-à-vis both large banks and unregulated lenders, at a time when capital markets are just beginning to facilitate access to capital for small business. This is inconsistent with the long-standing and active interest of Congress in expanding small business lending.

The current environment for small business lending is similar to that of the early 1970's, when a broader spectrum of individuals could obtain residential mortgage loans because lenders accessed more efficient funding by originating loans for sale in the secondary market. Secondary market forces very quickly and efficiently led to a standardization and self-policing discipline among first mortgage lenders, a pattern being repeated today in the small business area. The business-loan-backed securitization market has grown steadily over the past three years. In 1997 the volume totaled $715 million and increased 40% to $1 billion in 1998 and increased 50% in 1999 to $1.5 billion. The small-ticket leasing securitization market, which was a predecessor to this asset class, increased 26% in 1999 to total $14.5 billion.

First International Bank

Chartered in 1955, First International Bank is a wholly owned subsidiary of First International Bancorp, Inc. which is listed on the NASDAQ and is audited by a "Big 5" accounting firm. First International Bank has specialized over the past decade in lending to small, family-owned manufacturers, wholesalers, distributors, subcontractors and exporters. We are the most active combined user of the primary U. S. government small business loan guarantee programs. For the Federal fiscal year ending September 30, 2000, we ranked 11th nationally in the use of the Small Business Administration's 7(a) loan guarantee program measured by dollar volume and for the fiscal year ended September 30, 1999 (the latest period for which data is available) we ranked 1st in the use of the USDA Business & Industry loan guarantee program by dollar volume. For four years in a row, we have been the most active user of the small business loan programs offered by the Export-Import Bank of the United States measured by number of transactions (see attached rankings). The Bank received the President's "E" Award for export service from the U. S. Department of Commerce in May 2000 and was a 1997 winner of Ex-Im's Bank "Small Business Bank of the Year" award. In 1996, the Bank was selected to participate in the SBA Inspector General's "Best Practices" study.

We became active in U. S. government guarantee programs for small business during the 1989-1992 New England recession, and through these programs preserved up to an estimated 10,000 small business jobs during that "credit crunch." We found the federal small business loan guarantee programs especially accommodating during the recession and we were one of the few lenders willing and able to continue supporting small businesses during those times.

Our typical client has revenues of $1-$15 million and employs 10-100 people. The small business lending we do is either partially or entirely U. S. government guaranteed, or is made in connection with a government guaranteed loan. We have had good credit experience with such small businesses, our credit losses have been reasonable and we have an above average currency rate among SBA lenders.

We have been an active securitizer of small business loans, completing seven securitizations since June 1998 in this asset class totaling more than $325 million. In addition to such securitizations, we have sold the guaranteed portions of SBA, USDA and Ex-Im Bank loans originated, and we currently service a loan portfolio for ourselves and others totaling $1.2 billion.

The securitization market for this asset class has developed significantly since we began issuing small business loan-backed paper. While there was not an active market for junior classes in 1998, with more recent issues even the most junior bonds are now being sold at closing. The Bank nevertheless holds "residuals" comprised of junior bonds, interest-only strips and cash spread accounts related to its securitizations totaling $42.2 million at September 30, 2000. When these amounts are combined with residuals related to small business loans sold to off-balance sheet sales facilities and small business loan-related servicing assets, the total is $78.9 million which represents approximately 125% of the Bank's capital. Accordingly, we are among the institutions that would be most affected by the current proposal. However, based on discussions with various experts and a review of the literature available, we feel that we would be an unintended victim of the proposed new capital rules governing securitization activities.

We are affected because the scope of the proposed regulations includes securitization-related residuals related to <u>small business loans</u> and <u>commercial term loans to small businesses</u> and includes <u>non-mortgage related servicing assets to such borrowers</u> as "residuals" in the capital limitations.

<u>Impact of the Proposed Rule on the Riegle Act</u>

The proposed rules would effectively repeal, pre-empt, or at a minimum reinterpret, Section 208 of the Community Development and Regulatory Improvement Act of 1994 (the "Riegle Act" or the "Act"), several aspects of which relate to the Bank's small business lending activities as follows:

- Section 208 of the Act is explicit about Congressional recognition that small business is vital to U.S. economic growth and job creation, and that commercial banks provide the "majority" of capital to small business. Please note that an earlier section of the Act, (dealing with the establishment of Community Funds) also recognizes the need for capital availability in rural areas.

- The definition of small business as included in the Act includes virtually all the lending conducted by First International Bank under, and companion to, the SBA, USDA and Ex-Im Bank programs referred to above.

- Section 208 of the Act provides for preferential risk-based capital treatment for banks selling small business loans with recourse provided certain conditions, <u>including accounting consistent with GAAP</u>, a non-capital reserve to cover all credit losses and a 15% of capital aggregate cap on the amount of recourse, are satisfied. The preferential capital treatment of small business loans sold with recourse is only available to a well-capitalized bank. As a safeguard, calculations concerning capital status of a bank and prompt corrective action guidelines are made without regard to the preferential treatment afforded by Section 208. All of the bank regulatory agencies have issued regulations implementing the provisions of Section 208.

Although the proposed regulations do not specifically modify or amend the Act, because small business loans are not excluded from the scope of the regulations and there is a requirement for 100% capital against securitization-related residuals and non-mortgage related servicing assets to such borrowers, and a further sublimit that residuals not exceed 25% of total capital, the rules would have the effect of a significant modification to the Act. This would have an immediate and adverse impact on small business lending, which is counter to the intent of Congress to expand small business lending in enacting the Riegle Act.

<u>Adverse Impact on First International Bank and Similar Institutions</u>

If passed as drafted, the proposed regulations would severely limit our ability to provide capital to the small business sector in which we are expert. Further, our mandated exit from this market takes liquidity out of the market and reduces the financing alternatives available to small business, small exporters and small companies in rural areas. In the long-run, it also serves to make the bank charter, as a form of business, less viable since institutions such as ourselves might find themselves evolving toward the business of brokering small business loans for unregulated finance companies who would securitize such loans.

We understand that even when securitization activities have been conducted in accordance with current bank regulations, and accounted for in accordance with GAAP, and despite the fact that one of the objectives embodied in the Riegle Act was to encourage increased securitization of small business loans subject to safety and soundness considerations, there has been a negative reaction from field examiners this past year to securitization-related assets. Securitization-related assets are being classified substandard without regard to actual cash collection experience and despite the absence of material impairment deriving from credit quality, prepayment speed or interest rate movements. Further, institutions' overall risk profile and the adequacy of capital and liquidity are being assessed based on the provisions of the proposed regulations. The current examiner reaction to such residual holdings appears to be motivated by the proposed rule and may erroneously reinforce the perception that the proposed rule is necessary.

At September 30, 2000, our managed loan portfolio totaled $1.2 billion, 50% of which represented guaranteed loans sold to others, 16% were sold on a non-recourse "whole loan" basis, 12% were held on-balance sheet and 22% represented loans securitized or sold to commercial paper facilities. As evident from these statistics, unlike small, unregulated commercial finance companies, securitizations represent only one of several liquidity tools that we utilize to make capital available to small business. Such other tools include the sale of all three types of government guaranteed loans. The SBA and USDA guaranteed portions of the loans originated are sold to various parties and the Ex-Im Bank guaranteed loans are sold to the Private Export Funding Corporation ("PEFCO"), which has developed a number of secondary market programs to provide liquidity for Ex-Im Bank loans made to small business borrowers. We also utilize retail and brokered certificates of deposits (but work to effectively manage down on-balance sheet funding needs), on- and off-balance sheet funding facilities from Wall Street and Federal Home Loan Bank lines of credit.

While securitizations are not our only source of funding, they are a useful tool for us to manage and optimize liquidity. Access to this funding vehicle also allows us to offer a full complement of loans to small businesses, rather than limiting our product offerings exclusively to government guaranteed loans and low LTV first mortgages, which have active "whole loan" outlets. Interestingly, we have found that our ability to offer this "full service" financing approach actually results in improved credit quality and performance, and in the event that a borrower has financial difficulties we can act quickly to maximize our recovery, owing to the fact that we are often the only lender. An unfortunate result of the loss of access to securitizations would be our need to abandon this full service approach.

Small banks like First International Bank are a primary and important source of capital for small business. Effectively precluding securitizations leaves the field open to two types of lenders: a) big banks, which are not the best suited to serve small business customers especially during a slowing economy, and b) unregulated commercial finance companies, which are not as reliable providers of credit to small businesses compared to regulated banks.

Small Business Loan Residuals

We respectfully suggest that there are several misconceptions among the regulatory agencies about small business loan securitizations, which we believe cannot reasonably be compared with highly leveraged and riskier asset classes such as subprime mortgages, credit cards and other consumer loan assets.

- Our small business lending is generally variable rate, so prepayment speed is not necessarily impacted by changes in the interest rate environment.

- As noted above, our small business relationships generally involve more than one loan and are cross-collateralized, so it is not easy for a borrower to pre-pay a loan without incurring significant transaction costs. Prepayment penalties are very typical in USDA rural development loans, and just last week, new SBA legislation was signed into law allowing for prepayment penalties of 5%, 3% and 1% for the 1st, 2nd and 3rd years respectively, of loans with maturities of 15 years or longer. Such provisions provide built-in incentives for borrowers not to prepay.

- Securitization assets related to small business loans are well diversified in terms of industry sector, geographical area and borrower. The same is not true in the consumer sector. This point merits emphasis. While it may appear that a "concentration" exists when residuals aggregate a given percentage of capital, it is important to remember that those residuals are comprised of loans to a number of individual companies, in various industries and locations.

- Small businesses are the primary source of livelihood for their owners. And while there are certainly a number of small business start-up failures, it is possible to differentiate the portfolios of small business lenders. For example, we do not lend to companies who have been in business for less than 3 years, and our borrowers on average have been in business more than 10 years. They generally have evidenced great adaptability to survival during fluctuating economic environments.

We believe that the existing safety and soundness rules provide adequate controls for the proper supervision of banks that securitize loans.

- Securitization residuals are comprised of the small business loans originated, and the underlying loans are subject to the same risk classifications. So if regulators are comfortable with an institution's risk management capabilities, then internal risk rating criteria, combined with outside independently audited analysis under GAAP that validates "fair value", should suffice to quantify and control the risks of residuals.

- The regulatory concern that securitization causes the best assets to be sold, and the worst to be kept on balance sheet is, in certain cases, unfounded. The quality of the small business loan portfolio can be evaluated, and the quality of the loans comprising the residuals can be tested and verified in accordance with risk rating criteria in both independent audits and examinations. Indeed, if field examiners believe that there is serious potential for loss in residual holdings, their classifications can be extended to "doubtful" or "loss".

- The primary focus of regulators should be the assumptions underlying gain on sale calculation of residual asset values. If these are reasonable, and periodically testable and verifiable, then the residuals in and of themselves pose no undue risk.

- Certain of the government guarantee agencies require originating banks to keep residual exposures under their programs. Harshly treating these residuals for capital purposes will effectively constrain the ability of small banks to deliver SBA, USDA and Ex-Im loan programs to their small business customers.

- It is especially important to note that each of the guarantying agencies already have programs in place to monitor the performance of the lenders originating the loans they guaranty. More specifically, in response to their lenders' desire to access the securitization market for liquidity, the SBA has implemented a regulation that provides for the repeal of unsupervised lending authority of any securitizer whose loans show an incrementally higher delinquency rate.

- The SBA also requires that the lender retain ownership of a certain amount of the junior-most bond from a securitization. The amount of such retained bond is the higher of a prescribed minimum or twice the lender's 10-year historical loss rate. Each of the guarantying agencies encourage or require the loan originators to retain servicing.

- And, of course, the secondary market provides a strong incentive for a lender to follow prudent polices and practices in order to retain access to the securitization market.

Conclusions and Recommendations

It appears to us that the problems regulators have faced in dealing with securitizations by other institutions have to do with a) outright fraud, or b) different (riskier) consumer asset classes. Subjecting a small business lender to the proposed regulatory constraints would have the unintended adverse consequences described above. In other recent proposals to change the risk-based capital system, the regulatory agencies have been moving away from a "one size fits all" approach to capital. A tailored approach with an exercise of regulatory discretion that takes into account the characteristics of the institution and the asset class being created would likewise be appropriate for the supervision of institutions with securitization-related residuals and other small business related servicing assets.

1. Consistent with long-standing Congressional intent, the regulations should provide specific exclusions for:

   a. Securitization assets related to small business, rural development and export loans. It is critically important to the health of the U. S. economy and job market that small businesses continue to have access to financing. That access would be jeopardized under the current proposal. As noted above, existing safety and soundness rules provide adequate controls for the proper supervision of banks that securitize such asset classes.

   b. The new capital regulations should specifically exclude small business, rural development and export non-mortgage related servicing assets. This is warranted because these valuations are reasonably measured and because the guarantee agencies require that the originators retain the servicing in order that they remain accountable for the performance.

2. Generally accepted accounting principles and traditional loan risk rating procedures should be applied to the valuation of residual assets and the underlying loans.

3. All securitization assets currently on books of banks should be grandfathered, assuming they are accounted in accordance with GAAP and adequate polices and procedures (as defined in

the Interagency Guidelines published in December 1999 FIL 109-99) are in place. This is appropriate because:

- Institutions like us have a significant amount of time and money invested in current securitization activities, and participation in such activities was permitted under the then current bank regulations, and as noted in the Riegle Act, supported by Congress and public policy.

- It would be very time-consuming and costly to try to undo these transactions or to conduct a fire-sale of such assets. Assuming that residuals are appropriately valued, this would not be a productive use of bank management's time and would unnecessarily impair capital.

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We acknowledge that there have been some serious problems in banks and non-bank lenders engaged in securitization but we do not think the proposed regulation is the best way to prevent future problems. Most of the past problems can be traced to fraud or unrealistic estimates of gain-on-sale income and overvaluations of retained interests in securitizations. The problems that we have observed are typical of the kinds of overreaching experienced with new credit products during strong economic periods, when downside scenarios are considered remote, when the recklessness of a few lenders is not moderated by market discipline or up-to-date regulatory supervision, and when competition for market share is an especially driving force. Most participants in the securities markets have learned a great deal about securitization and residual valuations over the past several years. Going forward we think it is reasonable that "lenders will be viewing new transactions with greater caution than they did a couple of years ago, both bankers and their supervisors should now guard against allowing the pendulum to swing too far the other way by adopting policy stances that cut off credit to borrowers with credible prospects"[1]. Examiners who make use of the currently available enforcement tools will be able to head-off future securitization problems without risking the credit restrictions that the proposed rules would precipitate. We strongly urge the regulators to use the powers they presently have rather than to try to oppose new technologies that clearly benefit banks and small business borrowers.

[1] See remarks by Chairman Alan Greenspan, *Structural changes in the economy and financial markets,* at the America's Community Bankers Conference, December 5, 2000

Once again, I wish to thank you for the opportunity to comment on these very important regulations. We would be very pleased to provide further background or clarification on any of the points noted above. Please do not hesitate to contact me at 860-241-2529 (galbraithl@firstinterbank.com) or Brett N. Silvers, Chief Executive Officer, at 860-241-2513 (silversb@firstinterbank.com).

Sincerely,

Leslie Galbraith

President and Chief Operating Officer
First International Bank

CC: Jane P. Butler, U. S. Small Business Administration, Associate Administrator, Office of Financial Assistance
James Hammersley, U. S. Small Business Administration, Director, Office of Loan Programs
William F. Hagy, III USDA, Deputy Administrator Business Programs
James K. Hess, Export-Import Bank of the United States, Chief Financial Officer
Alfred Daiboch, PEFCO, Director of Small Business Programs

U.S. Small Business Administration's Top 7(a) Lenders In 2000

Ranked By Dollar Volume

Rank	Lender	$MM
1.	CIT Small Business Lenders	468.9
2.	Heller First Capital	459.2
3.	U.S. Bancorp.	409.0
4.	Bank United	370.8
5.	Wells Fargo Bank	332.2
6.	First Union Small Business Capital	318.2
7.	GE Capital	230.8
8.	Amresco Independence Funding	219.7
9.	Imperial Bank	202.9
10.	Fleet Bank	179.1
11.	**First International Bank**	**168.7**
12.	Banco Popular de Puerto Rico	164.4
13.	Comerica Bank	158.2
14.	Business Loan Center	137.6
15.	Transamerica Small Business	134.3
16.	Allied Capital	133.2
17.	Bank of America	124.7
18.	Compass Bank	122.3
19.	Business Lenders	111.3
20.	Bank One	105.7

Source: Coleman Publishing

USDA UNITED STATES DEPARTMENT OF AGRICULTURE

Department of Agriculture's Top Business & Industry Lenders in 1999

Dollar Volume In Millions

Rank	Lender	$ Millions
1.	First International Bank	$46.2
2.	B&I Lending LLC	$45.0
3.	Bank of America	$43.3
4.	Business Loan Center	$31.3
5.	Commerce Bank	$20.4
6.	Coop Bank	$20.0
7.	United National Bank	$20.0
8.	Palmetto Farm	$19.0
9.	Webbank	$18.3
10.	Banco Popular de Puerto Rico	$17.5
11.	Stearns County National Bank	$16.7
12.	Enterprise Capital	$14.8
13.	American National Bank	$14.8
14.	One Valley Bank	$13.4
15.	Carolina Capital Investment	$13.0
16.	Regency Bank	$12.8
17.	Sierra West Bank	$11.8
18.	Compass Bank	$11.7
19.	Key Bank	$11.6
20.	Community Trust Bank	$11.0

Source: Coleman Publishing

EXPORT

EXPORT-IMPORT BANK OF THE UNITED STATES OF AMERICA

U.S. Export-Import Bank's Top Lenders In 2000

Ranked By Number Of Transactions

Rank	Lender	No.
1.	**First International Bank**	**154**
2.	Allfirst Bank	55
3.	First Union Bank	52
4.	PNC Bank	40
5.	Bank One	34
6.	Bank of America	28
7.	Broadstreet, Inc.	28
8.	Citicorp	27
9.	Wells Fargo Bank	26
10.	Silicon Valley Bancshares	20
11.	Bank of New York	16
12.	SunTrust Bank	15
13.	Standard Chartered Bank	14
14.	Chase Manhattan Bank	12
15.	Southtrust Corp.	12
16.	ABN AMRO Bank	11
17.	Barclays PLC	9
18.	Bayerische Vereinsbank	9
19.	Webster Bank	9
20.	Lloyd's TSB Group PLC	8

Source: Export-Import Bank of the United States