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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. 200-70

Re: Residual Interests in Securitizations

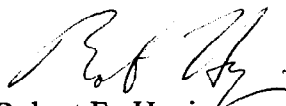
Ladies and Gentlemen:

On behalf of the organizations named on Schedule I to the enclosed letter, we are pleased to submit that letter. The letter comments on your September 2000 proposal relating to regulatory capital requirements for residual interests.

If you have any questions about the letter, please feel free to call any of the following:

- Vernon Wright, Vice Chairman & Chief Corporate Finance Officer, MBNA America Bank, N.A. at (302) 453-2074
- Robert Hugi, Partner, Mayer, Brown & Platt at (312) 701-7121
- Jason Kravitt, Co-Chairman, Mayer, Brown & Platt at (312) 701-7015 or (212) 506-2622

Yours very truly,


Robert F. Hugi

December 22, 2000

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal
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Robert E. Feldman
Executive Secretary
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Federal Deposit Insurance Corporation
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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:

The organizations listed on Schedule I (the “commenting group” or “we”) wish to thank the member agencies of the Federal Financial Institutions Examination Council (the “agencies” or “you”) for this opportunity to comment on the September 27, 2000 Notice of Proposed Rulemaking relating to residual interests in securitizations (the “proposal”).¹

Included in the commenting group (or in trade associations included in the commenting group) are organizations that regularly securitize a significant portion of the assets securitized by federally regulated financial institutions (“banks”). As a result, we are among the institutions that would be most affected by the proposal. We believe that we are also among the parties best qualified to speak to the risks embodied in various types of residual interests and the appropriate level of bank capital to absorb those risks.

The proposal would amend the Federal regulatory capital standards for banks in two ways:

1. It 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.
2. It would include residual interests in two existing deductions of servicing assets in calculating Tier 1 capital for leverage and risk-based capital purposes. Specifically:

¹ 65 Fed. Reg. 57993 (September 27, 2000).

- 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.

For convenience we refer to the change described in paragraph 1 above as the “*dollar-for-dollar capital requirement*” and the changes described in paragraph 2 as the “*Tier 1 deductions*.”

We recognize that the methods used to value some types of residual interests involve subjective judgments and assumptions. In extreme circumstances, these judgments and assumptions could theoretically inject uncertainty and volatility into a bank’s regulatory capital calculations. We support your efforts to develop appropriate supervisory tools to address these issues. We think that the dollar-for-dollar capital requirement could, with significant narrowing as suggested below, appropriately address your supervisory concerns.

As initially proposed, however, the expanded dollar-for-dollar capital requirement is overly broad and could materially increase regulatory capital requirements in circumstances where the risks retained by a bank do not justify the increase. We urge you to accept our suggestions below to narrow this requirement to apply only in the exceptional circumstances where the risks justify it.

Our objections to the Tier 1 deductions are more fundamental. We believe they duplicate the existing and proposed dollar-for-dollar capital requirements for residual interests. Consequently, we oppose including residual interests in the calculation of these deductions.

We comment in greater detail below on the dollar-for-dollar capital requirement (*Part II*) and the Tier 1 deductions (*Part III*). Before doing that, in *Part I* we provide some context for our comments, in terms of how the proposal would affect banks and other constituencies and how the concerns addressed by the proposal are already dealt with in normal business and market settings. In *Part IV* we comment on some other aspects of the proposal. Specifically, we (a) support the continuation and expansion of the current net-of-tax basis of computation of capital requirements for residual interests, (b) request drafting clarification as to the scope of the definition of “residual interest,” (c) comment on possible new call report disclosure on residual interests and (d) request that pre-existing transactions be grandfathered.

I. *Market Background*

The Tier 1 deductions would directly affect a number of banks, even where the bank's aggregate residual interests, considered alone, do not approach 25% (let alone 100%) of the bank's Tier I capital. In particular, due to the significant consolidation in the credit card business through portfolio purchases, some banks have built up substantial PCCRs. Under the proposal, a bank 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 bank's capital.

On the other hand, the dollar-for-dollar capital requirement would not have an immediate impact on many banks, including most of the asset-backed security issuers in the commenting group. The reason for this is that banks that issue asset-backed securities often do not retain interests in the transferred assets that aggregate more than the minimum on-balance sheet capital requirement for the transferred assets. In these circumstances, the dollar-for-dollar capital requirement would not increase a bank's required capital, since the existing low level recourse rule already requires banks to hold dollar-for-dollar capital against subordinated retained interests up to an amount equal to the on-balance sheet capital requirement.

However, for various reasons banks do sometimes retain residual interests in an aggregate amount that exceeds the related on-balance sheet capital requirement, particularly (a) where the underlying assets have a low risk weight or (b) in conduit transactions, if the conduit is restricted from buying lower than "A" or equivalent rated tranches or if for any reason it is not desirable to separately place another lower rated class. These banks would be affected by the dollar-for-dollar rule immediately.

In addition, the dollar-for-dollar capital requirement could deny banks a valuable future opportunity. One of the reasons that bank securitizers typically do not retain very large residual interests is the low-level recourse rule, which places a very large capital cost on each incremental dollar that a bank retains. This capital cost often overbalances other economic considerations that might otherwise lead a bank to retain additional interests.

This can most easily be illustrated by comparing the typical securitization behavior of bank credit card issuers with the behavior of retailers that securitize private label credit card receivables. Credit card-backed securities are generally issued in series through master trust structures, and each series typically includes two or three classes of interests: Class A securities, generally rated AAA or its equivalent; Class B securities, generally rated in the A category; and in some cases Class C securities, generally rated in the BBB category or structured so that the parties believe that they could be rated in that category. Bank issuers generally sell both or all three classes of securities, but retailers often sell only Class A or Classes A and B.

An important reason for this difference is a divergence in capital requirements. Even retailers that issue their private label credit cards through a special purpose credit

card bank or similar regulated entity are often able to structure their issuance activities so that any retained subordinated interests are funded by a non-regulated affiliate. As a result, there is no exceptional regulatory cost to retaining subordinated interests within the corporate group. The retailers are able to decide whether to sell or retain various classes based upon comparative costs of funds and other economic considerations. On the other hand, banks that reside in a traditional bank holding company structure (or otherwise do not have affiliates that can hold subordinated interests without creating substantial capital costs) have their incentives skewed towards selling off junior classes, even if that does not lead to the optimal overall cost of funding the business.

The agencies' March 2000 proposal relating to recourse and direct credit substitutes² has the potential to significantly change this calculation for banks 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.³ 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. As a result, even those of us who would not feel any immediate impact from the dollar-for-dollar capital requirement are concerned that it should not be adopted in its current overly broad formulation.

Most sophisticated banks that engage substantially in securitizing their own assets have well developed internal processes relating to that activity and have made substantial investments in related human resources and information technology. These internal processes include prudent means for valuing residual interests. In addition, the stock market does not look favorably on banking organizations that exhibit material earnings volatility resulting from aggressive gain on sale calculations. As a result, banks have market incentives to be prudent in the assumptions they use to calculate gain on sale. Also, new SFAS 140⁴ requires additional disclosures about assumptions used to value retained interests in securitizations and the effect of changes in those assumptions. These disclosures will enable the agencies and the market to better assess whether a bank's financial position will be materially affected by changes in the values of residual interests.

We believe that current capital rules require banks to hold more than enough capital in connection with securitized assets, both now and after giving effect to the March 2000 proposal. An increase in required capital above those levels is likely to either increase the cost of credit to consumers or impair the profitability of issuing banks as

² 65 Fed. Reg. 12320 (March 8, 2000).

³ Many of us have previously commented that the reduced capital treatment should also be available based upon approved internal risk rating systems, and we continue to believe that would be appropriate. Many of us have also suggested other changes to the proposed gradient and made various other related comments. Without restating all of those comments here, we request generally that any final rules adopted on the topics covered by the present proposal should be conformed with the March proposal as finally adopted, which we still hope will reflect all of our previous comments.

⁴ Statement of Financial Accounting Standards 140, paragraphs 17(f) and (g) (September, 2000). See further discussion in *Part IV.C.* below.

banks pass on the cost of additional capital to consumers, are driven to sell risk tranches rated lower than current practice in order to avoid excessive capital requirements or are unable to fully do either of the above. It is also likely to reduce the availability of consumer credit. Some banks may not be willing to commit the full amount of capital necessary to maintain their current or projected securitized portfolios, and competition from new entrants is likely to be reduced if the capital required for the business exceeds what is economically necessary.

II. *The Dollar-for-Dollar Capital Requirement*

The sophisticated institutions that have invested the time and resources to develop prudent valuation and other processes should not be subject to incremental capital requirements inspired by one or two extraordinary situations. To avoid this, we strongly favor a regulatory response that relies upon existing regulatory authority to impose additional capital requirements in problem situations. Existing and proposed bank regulations include numerous precedents for treating banks differently depending upon their sophistication, size and other factors. This is consistent with your general movement away from “one size fits all” regulations to more sensitive, market driven regulatory approaches. Also, in recent supervisory actions relating to particular institutions, 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 to limit a bank’s growth or holdings in a particular asset category.

Our preferred method for making the distinction here would be supervisory discretion, combined with enhanced disclosures that will already be required under SFAS 140 (and are discussed further in *Part IV.C.* below). Banks 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 banks, except banks that have qualified to use the current low level recourse and other capital rules through a regulatory approval process. We would also support this alternative, assuming that the qualification process was reasonable and the expanded dollar-for-dollar requirement did not take effect until sophisticated banks had been given time to go through the qualification process. We would be happy to work with you to develop appropriate qualification criteria, for instance by helping to identify best industry practices in this area.

If for any reason you decide that a new universally applicable rule is necessary, then we request that you make the following changes so that the new rule will only require additional capital when the risks inherent in particular residual interests justify it.

A. High Quality Exposures

Your March 2000 proposal would establish a graduated set of risk weights for residual interests and similar positions relating to securitizations of third party assets. Specifically, under that proposal, a residual interest that fell into one of the rating categories below would have the risk weight indicated. The same treatment would apply to unrated positions that rank senior to another class with one of the specified ratings.

Rating category	Examples	Risk weight
Highest or second highest investment grade	AAA or AA	20%
Third highest investment grade	A	50%
Lowest investment grade	BBB	100%
One category below investment grade	BB	200%
More than one category below investment grade, or not rated	B or not rated	"Gross-up" treatment

The March 2000 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 bank assets. We do not think that the supervisory concerns that have led you to issue the current proposal apply to instruments with ratings of BB- or above, nor do they invalidate the consensus positions reflected in the March 2000 proposal.

The March 2000 proposal also envisions limited use of approved internal bank rating systems for some capital-related purposes. Many members of the commenting group have previously suggested that approved internal systems should be a full substitute for external ratings in all contexts where the grid above applies.⁵ We have the same view here. We believe that banks 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.

Among other reasons, we support excluding appropriately rated positions from the dollar-for-dollar capital requirement because it would enable banks 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 bank 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

⁵ See footnote 3 above.

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, you could mandate special regulatory approval of the internal rating system of any bank that wishes to use its system to reduce the capital required for these types of assets.

B. *Gain on Sale Amount*

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 bank's balance sheet. This can only be justified in two circumstances:

- 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
- if the bank's balance sheet is exposed to more credit risk after the securitization than it was before the securitization.

As to the first point, as discussed above there are reasons other than asset quality that may lead a bank to retain a large residual interest. These include cost of funding considerations, low risk weighting of the underlying assets and execution types (particularly conduit transactions, as mentioned above). It is not appropriate to create a regulatory presumption that a large residual interest indicates particularly risky underlying assets.

If the agencies believe that some asset types need more than the normal 8% minimum/10% well-capitalized support from capital, you should address these asset categories on a uniform basis. You should not focus solely on pools that have been securitized in off-balance sheet transactions. Among other reasons, this would create artificial incentives against off-balance sheet securitizations. Because the capital results would be driven by the form of the transaction, the rule 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 the second bullet point above, we think that incremental risk for a bank 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 bank's balance sheet. For convenience, we will refer to assets created in this way as "*gain on sale assets*." Also, to the extent that you do not grandfather pre-existing transactions, we think that some gain on sale assets should be excluded from this calculation. Specifically, to the extent that a cash collateral account would otherwise be treated as a gain on sale asset, it should not be

so treated in transactions where the interest-only strip is not a residual interest.⁶ Most cash collateral accounts would not be gain on sale assets at all, since they are generally funded with sale proceeds and this reduces the cash proceeds received by the transferor.

If the only possible source of incremental credit risk to a bank is the creation of gain on sale assets, then incremental capital should only be required for gain on sale assets. Specifically, we think 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.

Our suggested modification is illustrated by the following examples. Each of the examples assumes a transfer of assets that have a risk weight of 100% (and therefore a minimum capital requirement of 8%). The examples also assume that the gain on sale assets are not rated (or that you do not accept our suggestion in *Part II.A* above) and as a result of that dollar-for-dollar incremental capital would be required for the gain on sale assets.⁷ The base for all percentages is the amount of the transferred assets.

⁶ Some institutions that sell only the AAA or equivalent tranches in their securitizations of certain asset types have provided unusually large cash collateral or similar accounts in transactions in order to create and retain an interest only strip receivable that does not absorb losses (and so is not a “residual interest”). A cash account of this type that provides equivalent enhancement to what the interest-only strip could have provided has a substantially higher carrying value than what the interest-only strip would have had if it absorbed losses, since the interest-only strip would be carried at the net present value of a stream of payments that would be received over a considerable period of time and would be net of estimated defaults. At the time that these transactions were completed, this difference in carrying values had no capital consequence, since the aggregate residual interests in order to sell only AAA securities exceeded the on-balance sheet capital requirement in either case.

⁷ We believe, however, that a smaller amount of incremental capital would be justified for many gain on sale assets. Ultimately, we believe that the required capital should be determined based on banks’ internal rating systems. Pending that, we suggest that it would be appropriate at least to vary the proportional amount of capital required against a gain on sale asset based upon the average life of the asset. Much of the possible volatility in the value of gain on sale assets comes from the need to make assumptions about future events, such as default and prepayment experience and interest rate movements. The shorter the time period covered by these assumptions, the less volatile the resulting valuations should be.

Amount of Residual Interest*	Gain on Sale Amount*	On-Balance Sheet Capital Requirement	Required Capital for Residual Interest Under Our Proposal	Required Capital for Residual Interest Under Agencies' Proposal
6%	Does not matter	8%	6%	6%
9%	0%	8%	8%	9%
9%	4%	8%	9%	9%
12%	4%	8%	12%	12%
15%	4%	8%	12%	15%
25%	1%	8%	9%	25%

* Net of tax provisions, as appropriate.

To be more precise, initially the “gain on sale amount” for a particular transfer should be determined as a result of the following formula:

- cash consideration received in the transfer, net of transaction expenses, *plus*
- carrying value of any residual interests (as defined in the proposal), *plus*
- carrying value of any retained interests in the transferred assets that are not “residual interests” because they do not absorb a greater than pro rata share of losses, *minus*
- net carrying value of the transferred assets immediately prior to the transfer (net of loss reserves), *minus*
- carrying value of any liabilities incurred in connection with the transfer, *minus*
- income taxes provided on the amount of the gain.

For instance, assume a securitization in which \$100 million of receivables are transferred to a trust. In return, the bank receives \$90 million of investor certificates, which are sold to an underwriter for \$89.5 million in cash, and a \$10 million subordinated certificate and also books a \$1 million interest-only strip asset. The subordinated certificate and the interest-only strip are both residual interests. The gain on sale calculation for the transfer would be:

\$89.50 million	Cash consideration
+ \$11.00 million	Carrying value of residual interests
+ \$0.00 million	Carrying value of other retained interest
- \$100.00 million	Carrying value of transferred assets
- <u>\$0.15 million</u>	Income taxes provided
<u>\$0.35 million</u>	Gain on sale amount

The gain on sale amount would be used to calculate the bank's capital requirements as of the end of the period in which the transfer occurred. In the example above, the required capital would be 8.35%, which is the sum of the 8% minimum on-balance sheet requirement plus the 0.35% gain on sale amount. This is less than the 11% capital requirement (before netting tax effects) that would result from your proposal as published.

In each subsequent period, the remaining gain on sale amount would be revalued, and the new value would be used to calculate the bank'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 bank should be permitted to choose a reasonable method that approximates GAAP. By way of illustration, we have suggested two possible methods below, but we would not support making these the exclusive methods.

In the first method, the bank would track the difference between the net income recognized to date on the related transaction and a pro forma calculation of the income that it would have recognized on the underlying assets if the securitization had been accounted for as a financing. In this pro forma calculation, the bank would:

- recognize interest income and servicing fees and provide for losses on the transferred assets as if they were on-balance sheet; and
- recognize interest expense on the associated beneficial interests as if they were on-balance sheet, as well as amortization of deferred fees and costs.

The interest income recognized on the retained interest and any other adjustments to residuals would also be computed. The gain on sale amount for periods after the one in which the transaction was completed would equal any net increase in capital resulting from sale vs. financing treatment of the transaction (before applying the dollar-for-dollar requirement), determined by comparing the bank's actual capital to what the bank's capital would have been if the pro forma items mentioned above had run through the bank's profit and loss statement.

The second method would be arguably less precise but administratively much simpler than the first one. In the second method, the gain on sale amount calculated for

the period in which the transaction occurred would be reduced in each subsequent period in proportion to the principal reductions of the underlying transferred assets.

C. Other Limitations

To avoid any doubt, you should make it clear that, for banks that qualify to use the agencies' market value capital rules for their trading account, the dollar-for-dollar capital requirement applies only to assets that are held in a bank'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 bank and should not apply at the consolidated holding company level.

III. The Tier 1 Deductions

We oppose 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 banks 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 banks to hold capital in excess of their maximum recourse exposures. The dollar-for-dollar capital requirement will require capital coverage for 100% of a bank's exposure in all cases (if the proposal is adopted as proposed) or many cases (if the proposal is modified as we suggest). 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 bank's capital in excess of their balance sheet carrying values.

As the agencies acknowledged in the proposal, this is not the first time that you 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.”⁸

The agencies made the right choice at that time in viewing the Tier 1 deductions as an alternative to recourse treatment and not something that should be applied in a duplicative manner to an asset type that is already covered by the recourse rule. We urge you to continue that approach now, as the same rationale still applies.

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

1. “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.”
2. “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.”⁹

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 we have 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 bank’s assets may be in this area, it is hard to see a rationale for requiring banks 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 you nevertheless decide to change your current approach and impose these duplicative requirements, we ask that you at least 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, we would ask that you increase the 25% and 100% thresholds to 75% and 150%, respectively, to accommodate the addition of a new asset type to the categories that are subject to those limits. Alternatively, you could establish a separate Tier 1 limit for this asset category.

Also, we think that if any residual interests are going to be included in calculation of the Tier 1 deductions, it should only be interest-only strips receivable. Retained

⁸ 63 Fed. Reg. 42667, 42672 (August 10, 1998).

⁹ 65 Fed. Reg. 57996-7.

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 you 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 also 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.
- If the capital requirement relating to a residual interest is less than or equal to the amount of the residual interest because of the limitation we proposed in *Part II.B.*, then only the portion of our proposed required capital relating to a residual interest in excess of the on-balance sheet capital requirement should be counted towards the Tier 1 deductions. For instance in the example we described in *Part II.B.*, where the required capital would be 8.35% under our proposal, only 0.35% should be counted towards the Tier 1 deductions .

IV. *Other Comments*

A. *Net-of-Tax Calculations*

We support the agencies' initial decision to continue to apply the capital requirements for residual interests on a net-of-tax basis. We also believe that treatment should be expanded in one respect.

Your current policy of calculating capital requirements for residual interests on a net-of-tax basis is consistent with economic reality. For example, an interest-only strip receivable is effectively "linked" to the related change in the bank's deferred tax position. This is not a situation where the interest-only strip receivable could be written off, but the bank 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 bank's tax liabilities. To the extent that any of the agencies do not currently permit this netting, we submit that 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 not deferred. 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 already paid. Given the risk-free nature of a refund claim against the U.S. Treasury, the future economic benefit through reduced future taxes or increased refund is economically equivalent to the rationale for the existing rule.

B. *Scope*

Besides the substantive changes to the definition of "residual interest" discussed in *Parts II* and *III*, we also request one clarifying change. The definition, as proposed to be adopted by each of the agencies, includes three elements:

1. an initial sentence that provides a substantive definition of the term (essentially, retained interests in transferred assets that absorb more than a pro rata share of credit risk);
2. a statement that purchased interests with the same economic characteristics are not included; and
3. a listing of the typical examples of residual interests (interest-only strips receivable, spread accounts, cash collateral accounts, retained subordinated interests).

We believe that the listing of typical examples in the third element is meant to be subject to the substantive definition in the first element. For example, an interest-only strip receivable is only meant to be included as a residual interest if it absorbs more than a pro rata share of credit risk. However, the various agencies' formulations of this element differ from one another and some are not completely clear on this point. We request that each of the agencies make this very clear, for instance by using the following formulation for the third element:

Examples of assets that typically constitute residual interests are interest-only strips receivable, spread accounts, cash collateral accounts, retained subordinated interests and similar on-balance sheet assets that function as a credit enhancement; however, 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.

C. *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." We believe that the

supervisory concerns that motivated your proposal are analogous to the concepts behind the FASB's preliminary views. We agree with the Federal Reserve Board that analytical disclosures are an appropriate way to deal with these types of valuation concerns.

We submit that the new disclosures about securitization transactions required by the recently adopted SFAS 140 will fully address this need. These new annual disclosures (which become effective for calendar years ended December 31, 2000) present very detailed information about the nature of retained interests, valuation assumptions, sensitivities and the cash flows between the bank and securitization trusts or other special purpose vehicles. These disclosures will provide ample information for the agencies. For your convenience, we have attached the relevant excerpts from SFAS 140 to this letter. The staff of the Securities and Exchange Commission recently addressed auditors about these requirements, indicating the significant attention that the Commission is giving to these matters.¹⁰

To avoid duplication of reporting effort, banks should be given the option of incorporating by reference information from their most current annual audited financial statements with their annual regulatory filings. Banks 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. Developing a second set of year-end disclosure data would be a significant reporting effort that could 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 banks, and could for many banks jeopardize the timely filing of their interim reports. We strongly believe that the GAAP disclosure and reporting framework will provide the agencies with adequate information to carry out their regulatory oversight functions.

D. Grandfathering

Finally, we ask 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 banks 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. The situation discussed in footnote 6 above is a particular example where grandfathering would be amply justified. If you do not provide blanket grandfathering, we request that you at least

¹⁰ Remarks by David A. Kane, Professional Accounting Fellow, Office of the Chief Accountant, U.S. Securities & Exchange Commission at the 28th Annual National Conference on Current SEC Developments December 4, 2000. Available at <http://www.sec.gov/news/speeches/spch432.htm>.

provide a mechanism for particular transactions like those to be grandfathered where the circumstances clearly justify it.

To help you assess the time period that would be necessary to roll through the effects of the requested grandfathering, we have set out below a table that projects the remaining maturities of currently outstanding public bank asset-backed securitizations.¹¹ Based upon these projections, over 85% of the outstanding asset-backed securities publicly issued by banks will pay down over the next five years.

(dollars in millions)

End of Year	Total	% Cumulative Change	Credit Card	Auto Loans & Leases	Home Equity	Other*
2000	\$ 315,572	n/a	\$ 223,729	\$ 16,674	\$ 53,511	\$ 21,658
2001	260,174	-17.6%	188,301	8,884	44,021	18,967
2002	203,425	-35.5%	148,376	3,941	34,818	16,290
2003	137,489	-56.4%	96,640	1,310	25,876	13,663
2004	91,467	-71.0%	64,155	-	17,545	9,768
2005	46,131	-85.4%	27,090	-	10,463	8,577
2006	28,084	-91.1%	16,906	-	5,384	5,794
2007	16,806	-94.7%	10,084	-	2,447	4,275
2008	10,118	-96.8%	6,361	-	1,002	2,755
2009	\$ 4,774	-98.5%	\$ 3,015	\$ -	\$ 509	\$ 1,250

* Includes collateralized loan obligations, student loans and small business loans.

Source: Credit Suisse First Boston

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We thank you again for this opportunity to comment. As always, we would be happy to discuss these matters further if you would find that helpful.

Respectfully submitted.

¹¹ Like any projections, these involve some assumptions and estimates. Mortgage-backed securities and private placements (including Rule 144A and conduit transactions) are not included.

Commenting Group

Alston & Bird LLP
America's Community Bankers
Banc of America Securities LLC
Bank of America
Bank of New York
Capital One Financial Corporation
The Chase Manhattan Corporation
Citigroup Inc.
Deutsche Banc Alex. Brown
Discover Bank
FleetBoston Financial Corporation
J.P. Morgan & Co. Incorporated
Mayer, Brown & Platt
MBNA Corporation
Metris Companies Inc.
Morgan Stanley Dean Witter & Co.
National City Corporation
Orrick, Herrington & Sutcliffe LLP
Peoples Bank
Provident Bank
Providian Financial Corporation
Wachovia Bank, N.A
Wells Fargo & Company

Paragraphs 17(f) and (g) of SFAS 140

17. An entity shall disclose the following: . . .
- f. If the entity has securitized financial assets during any period presented and accounts for that transfer as a sale, for each major asset type (for example, mortgage loans, credit card receivables, and automobile loans):
- (1) Its accounting policies for initially measuring the retained interests, if any, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (paragraphs 68-70)
 - (2) The characteristics of securitizations (a description of the transferor's continuing involvement with the transferred assets, including, but not limited to, servicing, recourse, and restrictions on retained interests) and the gain or loss from sale of financial assets in securitizations
 - (3) The key assumptions⁷ used in measuring the fair value of retained interests at the time of securitization (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets,⁸ and anticipated credit losses, if applicable)
 - (4) Cash flows between the securitization SPE and the transferor, unless reported separately elsewhere in the financial statements or notes (including proceeds from new securitizations, proceeds from collections reinvested in revolving-period securitizations, purchases of delinquent or foreclosed loans, servicing fees, and cash flows received on interests retained)
- g. If the entity has retained interests in securitized financial assets at the date of the latest statement of financial position presented, for each major asset type (for example, mortgage loans, credit card receivables, and automobile loans):
- (1) Its accounting policies for subsequently measuring those retained interests, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (paragraphs 68-70)

⁷ If an entity has made multiple securitizations of the same major asset type during a period, it may disclose the range of assumptions.

⁸ The weighted-average life of prepayable assets in periods (for example, months or years) can be calculated by multiplying the principal collections expected in each future period by the number of periods until that future period, summing those products, and dividing the sum by the initial principal balance.

- (2) The key assumptions used in subsequently measuring the fair value of those interests (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, including expected static pool losses,⁹ if applicable)
- (3) A sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests of two or more unfavorable variations from the expected levels for each key assumption that is reported under (2) above independently from any change in another key assumption, and a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test
- (4) For the securitized assets and any other financial assets that it manages together with them:¹⁰
 - (a) The total principal amount outstanding, the portion that has been derecognized, and the portion that continues to be recognized in each category reported in the statement of financial position, at the end of the period
 - (b) Delinquencies at the end of the period
 - (c) Credit losses, net of recoveries, during the period

Disclosure of average balances during the period is encouraged, but not required.

⁹ Expected static pool losses can be calculated by summing the actual and projected future credit losses and dividing the sum by the original balance of the pool of assets.

¹⁰ Excluding securitized assets that an entity continues to service but with which it has no other continuing involvement.