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NEW YORK CLEARING HOUSE

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December 26, 2000

Communications Division,
Office of the Comptroller of the Currency,
250 E Street, S.W.,
Washington, DC 20219,
Docket No. 00-17.

Robert E. Feldman,
Executive Secretary,
Comments/OES,
Federal Deposit Insurance Corporation,
550 17th Street, N.W.,
Washington, D.C. 20429.

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

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

Re: Capital Requirements for Certain Residual Assets

Dear Ladies and Gentlemen:

The member banks of The New York Clearing House Association L.L.C. (the "Clearing House"),* Bank of America, N.A., First Union National Bank and Wells Fargo Bank, N.A. appreciate the opportunity to comment on the proposal by the Office of the Comptroller of

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* The member banks of the Clearing House are: The Bank of New York, The Chase Manhattan Bank, Citibank, N.A., Morgan Guaranty Trust Company of New York, Bankers Trust Company, Fleet National Bank, European American Bank, and HSBC Bank USA.

the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision (the "Agencies") to amend the capital adequacy standards in respect of certain residual interests in asset securitization (the "Proposal"). 65 Fed. Reg. 57993 (Sept. 27, 2000). A number of our member banks are active in making loans and then securitizing them so that they can both fulfill the public's credit needs and minimize credit and funding risk. We are, therefore, vitally interested in a proposal that could materially alter that business and place U.S. banks at a competitive disadvantage.

The Clearing House supports the general principle, enunciated in the Proposal, of aligning risk-based capital standards more closely with the actual risk involved. We believe, however, that it is essential that this principle be implemented universally, and not just in response to specific regulatory concerns.

Beyond this general principle, we urge the Agencies to make several key modifications in the Proposal so that the objective of preventing unsound banking practices can be achieved without penalizing sound banking practices, imposing capital standards that exaggerate actual risk or creating unwarranted competitive disparities. In adopting a final capital rule, the Agencies should recognize not only the potential risk in certain residual interests at certain banks, but the risk that, if the new rules are unduly harsh, they could cause a contraction of credit, an increase in credit and funding risk, or both. Banks would not make certain loans if they could not limit both the capital and liquidity risks through securitization. As the Agencies recognize, "[s]ecuritizations provide an efficient mechanism for banking organizations to sell

loan assets." 65 Fed. Reg. at 57994. The following comments are directed to maintaining this balance.

1. Rationale for the Proposal; Internal Models.

The Agencies' stated rationale for adopting both a special capital requirement and a special capital charge for residual interests is their high level of risk. We believe that the optimum approach for dealing with potential special risk situations, such as residual interests, is to permit banks with demonstrated experience and expertise to utilize their own internal models to evaluate the risk and allocate an appropriate level of capital. This approach minimizes the inherent problem that occurs when a universally-applied rule designed to avoid unsound banking practices at some banks also discourages sound banking practices at other banks. We urge the Agencies to permit banks with demonstrated expertise in evaluating residual risk to use an internal model approach.

The risks and concerns identified in the Proposal provide perhaps the best evidence why an internal model option is appropriate. For example, the Proposal asserts that residual interests "are generally retained by the securitizing institution rather than sold because they are generally illiquid and volatile in nature". 65 Fed. Reg. at 57997. As the use of the qualifying term "generally" presumably recognizes, in some cases, residual interests are retained for reasons that have nothing to do with special risk. One important reason why a bank may elect to retain rather than sell the residual interest is that the bank believes that its greater knowledge of the asset pool enables it to achieve greater value by retention. The use of an internal model

approach would enable a bank -- and the regulators -- to distinguish between residuals that are retained because of special risk and those that are retained for other reasons.

Likewise, the Proposal expresses concern about the "leveraged" feature of certain residuals, which makes them "extremely sensitive" to various market conditions. 65 Fed. Reg. at 57993, 57995. A universal capital rule, such as the Proposal, however, fails to distinguish between residual interests with a substantial element of this type of leverage and those that have minimal leverage. Another concern addressed by the Proposal relates to the securitization of "low quality higher risk loans", but the Proposal would cover all securitized loans, irrespective of the risk. 65 Fed. Reg. at 57994. As a final example, the Proposal relates to significant weaknesses in the risk management process at "certain institutions", but clearly not all institutions. Id. An internal model approach can make these distinctions.

We believe that the use of internal models is particularly appropriate after the residual has "aged" so that anticipated performance can be compared with actual performance. Assuming a general level of correlation, we believe that banks with demonstrated expertise and experience should, at a minimum, be able to use internal models after the first anniversary of the residual.

2. External Ratings and Other Extrinsic Evidence of Valuation.

If the Agencies do not permit the use of internal models, we believe that they should permit the use of external ratings and other extrinsic evidence to limit the scope of special capital rules to those residual interests where there truly is special risk. The Proposal's definition of residual interest is so broad that it includes interests where the risk is not special or unusual.

In describing residual interests, the Proposal refers to them as generally "non-investment grade or unrated" assets that provide "first loss" protection and that "generally lack an active market though which a readily available market price can be obtained". 65 Fed. Reg. at 57993. Although this description may fit some residual interests, it does not fit others. For example, the residual interest may be investment grade because it is supported by a spread account or a more subordinate interest.

Nonetheless, the definition of "residual interest" encompasses such interests irrespective of whether they are investment grade or have a sufficiently active market that a readily available market price can be obtained. At the very least, we believe that the definition of "residual interest" should be amended to exclude all interests that are investment grade (BBB or better) or for which a readily available market price can be obtained. Indeed, we believe that any interest that has a rating of BB or better should be excluded from the definition of residual interest because the credit risk is comparable to many bank loans made in the ordinary course of business.*

3. Special Capital Requirement.

The Clearing House believes that the principal risk with residual interests has occurred where a bank has both booked a large residual interest and recognized a significant gain on sale. The Agencies appear to concur in this view. 65 Fed. Reg. at 57995. We, therefore, urge

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* The Clearing House believes that the use of internal models at banks with sophisticated risk valuation processes is clearly superior to external ratings. Accordingly, we regard this external rating approach as only an interim step that should be replaced as soon as possible by internal models.

the Agencies to focus the special capital requirement on the gain on sale situation where special risk arises. More specifically, we recommend that when the residual interest exceeds 8% of the securitized assets, the general capital requirement should be the sum of (i) 8% of the securitized assets and (ii) the lesser of (x) the gain on sale and (y) the excess of the residual over 8%.* This protects against the case where the bank has retained a large residual interest for the purpose of enhancing the gain on sale.

In considering our recommended requirement (as well as the special capital charge discussed below), it is important to recognize the conservative nature of the recommendation. Using the example in the Proposal, a 15% residual and a 3% gain on sale, the residual interest would be risk-weighted at 17.2 ([100 x 11/8] ÷ 8) times the risk weighting generally applied to assets. Indeed, the current low level recourse capital requirement is already quite conservative. Under the current low level recourse approach, the residual interests are risk-weighted at 12 ½ (100 ÷ 8) times the risk weighting generally applied to assets.

4. Special Capital Charge.

The Clearing House believes that a special capital charge, as opposed to a higher risk-weighting, is almost never warranted. The imposition of a capital charge is contrary to the very concept of a risk-based capital system because it suggests that the risk cannot be evaluated. Accordingly, we recommend that residual interests should not be subject to any sublimit-based capital charge.

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* In the case of residual interests in first mortgages (which are risk-weighted at 50%), the capital requirement would be the sum of (i) 4% of the securitized assets and (ii) the lesser of (x) the gain on sale and (y) the excess of the residual over 4%.

The concept of a special sublimit charge is attributed in the Proposal to concerns about excessive concentrations. We believe, however, that such concerns should be dealt with through the bank-specific supervisory process rather than a "one size fits all" prohibitory capital approach. A level of residual interests may be excessive at one bank because the bank lacks experience and expertise, while not creating a problem at a second bank that has experience and expertise.

If a sublimit charge is to be applied, it should be separate from the 25% limit on nonmortgage servicing assets (NMSAs) and purchased credit card receivables (PCCRs) and from the 100% limit on mortgage servicing assets (MSAs), NMSAs and PCCRs. We see no basis for combining residual interests with NMSAs and PCCRs, much less MSAs. Although the Proposal attempts to delineate certain similarities, these other assets have different risk characteristics from those of residual interests. For example, PCCRs do not have the "leveraging" aspect of many residual interests that is of specific concern to the Agencies. 65 Fed. Reg. at 57995. We, therefore, recommend that any sublimit charge be applied to residual interests alone.

If residual interests are combined with these other assets, then it is essential to raise the percentage of capital standard (which we believe should be done virtually irrespective of the treatment of residual interests). We recommend that the NMSA/PCCR sublimit be raised to 75% and the NMSA/PCCR/MSA sublimit be raised to 150%.

5. Allocation of Special Capital Charge.

The sublimit-based special capital charge would be applied against Tier 1 capital. Although such an allocation is obviously the only possible outcome when the charge is applied

in calculating the leverage capital ratio, it is inconsistent with the overall approach to risk-based capital. Tier 2 capital as well as Tier 1 capital is available to absorb losses. Because of the special nature of the charge, we believe that it would be more appropriately allocated to Tier 2 capital. At the very least, the charge should be split on a 50-50 basis between Tier 1 and Tier 2. The need for this recommended allocation becomes more pressing if the residual interests continue to be lumped together with PCCRs, NMSAs and MSAs. In addition, in view of the Agencies' own reservations about the continued appropriateness of a leverage ratio, and its inconsistency with the Basle capital regime, we believe that a special charge against the leverage ratio is particularly inappropriate.

6. Double "Hit".

The Clearing House assumes that the Agencies did not intend for residual interests to be subject to both a capital charge and a capital requirement. If a residual interest exceeds a special sublimit, and is therefore deducted from Tier 1 capital, then the interest would also be deducted from the denominator of the capital calculation and no capital assigned to it. See 12 C.F.R. 225, App. A, n. 14. Otherwise, residual interests would require 200% capital.

7. Deferred Tax Treatment.

The Clearing House supports the first of the two alternatives (the "at-risk" amount) suggested by the Agencies for treatment of deferred tax liabilities. 65 Fed. Reg. at 57998, n. 19. As the Proposal notes, in a worst case scenario, the values of both the residual interest and the tax liability decline to zero, and the actual capital loss is the net of the two items. This approach, therefore, measures actual risk more accurately than the approach outlined in the

text of the Proposal. At the very least, the Proposal's net-of-tax treatment should be used rather than the gross basis approach.

8. Retroactive Impact; Effective Date.

The Clearing House urges the Agencies not to apply the new capital rules to transactions completed before the publication of the Proposal. The potentially draconian capital impact makes retroactive application of new rules to transactions entered into in good faith particularly inequitable.

In any event, because the new rule could have a significant impact on bank capital planning, we urge that it not be effective until the end of the quarter following the quarter in which it is adopted.

9. Trading Account Assets.

We believe that a special capital requirement or charge is particularly inappropriate for residual interests held in a trading book, where the value must be continuously assessed and marked-to-market. If the value declines and the capital charge/requirement does not decline as well, a bank would, in effect, be required to hold capital for more than 100% of the maximum risk on the asset. If, however, the capital requirement increases as the value of the asset increases, then the bank will ironically be required to hold more capital because the risk has declined.

10. Plain Language.

Notwithstanding the technical and complex nature of the Proposal, we believe that it is clear and well written, and satisfies the plain language requirement of the Gramm-Leach-Bliley Act.

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In conclusion, we recognize that the Agencies have a primary responsibility to ensure the safety and soundness of the banking system, but we urge them to take into account all aspects of the safety and soundness issue in formulating special capital rules. More specifically, if the special capital rules in the Proposal render U.S. banking organizations uncompetitive for various types of loans and other products, it reduces or even eliminates an important source of earnings. We do not believe that the rating agencies or the marketplace generally imposes capital requirements as stringent as those in the Proposal, at least for banks with substantial expertise in asset securitization. Accordingly, banks will be placed at a competitive disadvantage in relation to nonbank lenders, broker-dealers and foreign banks.

We also urge the Agencies to take into account the potential impact of the Proposal on credit availability. If banks can not make certain loans profitably and safely, after taking into account the funding and risk reduction advantages of securitization, they will cease making those loans.

We appreciate your consideration of these comments. Please feel free to call Norman Nelson (212-612-9205), General Counsel of the Clearing House, if you have any questions.

Very truly yours,

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