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December 22, 2000

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

Robert Feldman
Executive Secretary
Attention: Comments/OES
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

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

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

Re: Residual Interests in Asset Securitizations or Other Transfers of Financial Assets.
165 Fed. Reg. 57993 (September 27, 2000).

Dear Sir or Madam:

America's Community Bankers (ACB) appreciates this opportunity to comment on the proposed rule on residual interests, which would impose new leverage and risk-based capital requirements on residuals retained in securitizations. ACB represents the nation's community banks of all charter types and sizes. ACB members pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.

The proposed residual interest rule would amend the regulatory capital requirements for banks in three respects.

- (1) Risk-based capital would be required to be held in an amount equal to the amount of the residual interest that is retained on the balance sheet by the bank, even if the capital charge exceeds the full risk-based capital charge typically held against the transferred assets.
- (2) Residual interests would be included within the 25 percent of Tier 1 capital sublimit already placed upon nonmortgage servicing assets and purchased credit card receivables (PCCRs). Any amounts of residual interests, which when aggregated with nonmortgage servicing assets and PCCRs exceed 25 percent of Tier 1 capital, would be deducted from Tier 1 capital for purposes of calculating both the risk-based and leverage capital ratios.

- (3) The maximum allowable amount of mortgage servicing assets, PCCRs, nonmortgage servicing assets, and residual interests, in the aggregate, would be limited to 100 percent of the amount of Tier 1 capital that exists before the deduction of any disallowed mortgage servicing assets, any disallowed PCCRs, and disallowed nonmortgage servicing assets, any disallowed residual interests, and any disallowed deferred tax assets. The residual interests, however, would not be subject to the 90 percent of fair value limitation that applies to servicing assets and PCCRs.

ACB's Position

Though only a relatively small number of depository institutions engage in the activities covered by the proposal, ACB does have members that would be affected by its provisions, and consequently ACB considers the potential impact of the proposal to be a matter of concern. ACB is concerned that the proposed rule may be an overreaction to the unsophisticated or fraudulent valuations of their residuals by a few institutions. We believe that the best approach to minimizing the balance sheet volatility that could be created by significant retention of residual interests is to require the consistent use of appropriate risk rating systems. The proposed dollar-for-dollar capital requirement indiscriminately increases regulatory capital requirements, such that the prudent business activities of institutions using effective risk management techniques would be inhibited unjustifiably. ACB recommends an alternative capital proposal that, we believe, is more appropriate than the dollar-for-dollar requirement. Furthermore, ACB objects to the proposed inclusion of retained residuals with other amounts currently deducted from Tier 1 capital. The proposed Tier 1 requirements are duplicative of, not only the proposed dollar-for-dollar requirement, but of the existing low-level recourse requirements.

The Dollar-for-Dollar Capital Requirement

Realistically, many securitizers may not be affected by the proposed dollar-for-dollar capital requirement because they are discouraged from retaining significant residual interests by the current low-level recourse rule. Increasing capital requirements in response to isolated problems can be both a crutch for regulators to use as a substitute for flexibility and sound judgment and a club that prevents well-managed institutions from executing sound business decisions. The dollar-for-dollar requirement in the proposed residual interest rule may deter a bank from holding a significant residual interest that would otherwise be completely justifiable based on the low risk weight of the securitized assets.

ACB disagrees with the approach of the proposed residual interest rule and the current recourse capital rules. The better approach to determining appropriate capital requirements for retained residuals is the one taken in the recently proposed rule on securitizations.¹ Under this proposed securitization rule, the risk weighting for retained subordinated interests varies depending on their investment rating. A

¹ 65 Fed. Reg. 12320 (March 8, 2000).

subordinated interest with an investment grade of AAA or AA is risk weighted at 20%. An investment grade of A is 50% risk weighted and an investment grade of BBB is 100% risk weighted. One grade below investment grade is 200% risk weighted. More than one grade category below investment grade, or not rated, the subordinated interest receives "gross-up" treatment.

The proposed securitization rule appropriately recognizes that all subordinated interests should not be treated alike. The preamble to the proposed residual interest rule points out the principal difference between the new proposed residual interest rule and the prior proposed securitization rule – the latter distinguishes residual interests based upon their credit quality. ACB believes that the residual and securitization proposals should be reconciled by acknowledging that, where a residual interest is rated investment grade or better, the more appropriate capital requirement is that of the securitization proposal. A residual interest that can be rated investment grade does not give rise to the concerns that appear to have prompted the issuance of the residual interest proposal.

In addition, the proposed securitization rule would permit a bank with a qualifying internal risk rating system to use that system to apply the ratings-based approach to unrated direct credit substitutes – other than retained recourse positions.² This approach is consistent with that of the Basel Committee's June 1999 Consultive Paper, which discusses determining bank capital requirements based on external or internal credit ratings of bank assets.

To profitably manage continuing asset securitization a bank must necessarily implement a sophisticated system of internal controls and information technology – including valuation methodologies for residual interests. ACB believes that approved internal systems should be a full substitute for external ratings in all contexts where the proposed securitization rule would apply. In other words, banks with qualifying internal risk rating systems should be permitted to use internal ratings comparable to those in the proposed securitization rule as the exclusive determinant of the capital requirements for residual interests. Specifically, we propose that only those institutions rated CAMEL 2 or better would be permitted to use an internal risk rating system to apply the ratings-based capital requirements of the proposed securitization rule to unrated retained residuals. Such an institution's internal risk rating system would be subject to subsequent supervisory approval, but this approval should not be unreasonably withheld.

As noted in the preamble to the proposed residual interest rule, the regulators reserve the right to impose a notional higher risk-based capital requirement on the underlying assets and a correspondingly greater requirement on the residual. Given the supervisory option of imposing individual minimum capital requirements on any entity where there is an undue exposure not captured by the overall risk-based approach, it is not clear why this individualized approach could not be substituted for the entire complex apparatus of the proposed rule. The small universe of affected entities makes the treatment of residuals an ideal test bed for supervisory flexibility. A case-by-case approach to the determination of

² 65 Fed. Reg. 12320, at 12329

the capital to be held against retained residuals would very likely be more workable and less contentious.

Required Residual Capital Would Exceed Required Whole Asset Capital

ACB is concerned that the overall approach of the capitalization of recourse proposals, and, *a fortiori*, the treatment of residuals in the current proposal, do not observe the reasonable requirement of producing the same overall capital support whether the underlying assets are held on-balance-sheet by the originating depository institution or represented by securities sold to other insured depositories. While many investors in the senior paper are not depositories, the capital computation should be consistent as if that were to be their destination. This consistency constraint is a natural benchmark for determining the reasonableness of the recourse standard in the context of the overall risk-based capital regime.

It is regulatory overkill to require substantially more capital to be held against the residual interest retained from a securitized loan than would be required to be held against the entire interest in the loan, if it were still on the balance sheet. The preamble to the proposal seems to show some sensitivity to this concern by noting that the proposal could produce an outcome where “the capital charge exceeds the full risk-based charge typically held against the transferred assets.”³

The proposal’s justification for this outcome is the necessity of protecting against the possibility of manufacturing ephemeral profits and capital from the use of ‘gain on sale’ accounting to recognize the transfer of beneficial ownership under the securitization. ACB’s position is that this proposed protection is not justifiable on a cost/benefit basis because adequate protections against gain on sale inflation have now been built into GAAP. The FASB has addressed the gain on sale issue in its new statement on securitization, Statement No. 140, by requiring extensive disclosures about methodologies, assumptions, and financial information used to value the retained interests. The same kinds of disclosures are required with respect to subsequent fair value measurement of the retained residuals.⁴

ACB also believes that, apart from those institutions intent on outright fraud, the fact that the market will inevitably punish those institutions whose unrealistic residuals valuations trigger earnings volatility is an effective disincentive to unbridled gain on sale optimism. We note that the proposed rule does not include purchased residuals, but focuses only on originated residuals. Here the proposal recognizes the supervisory value of the markets’ scrutiny. ACB supports the restriction of the proposal to originated residuals.

³ 65 Fed. Reg. 57933 (September 27,2000).

⁴ See FASB Statement 140, at paragraphs 17(f) and (g).

As the preamble to the proposal notes, gain on sale calculations may be “extremely sensitive to changes in the underlying credit and prepayment assumptions.” ACB, however, also notes that there may be legitimate gain on sale from seasoned rather than pipeline product fed into securitization transactions where an element of the added market-recognized value is from prepayment experience that is favorable to investors. We believe that the proposed rule reflects undue suspicion and fear of structured credit exposure with respect to gain on sale calculations in the market today. While supervisory skepticism about the overall reliability of these capital sources is warranted, the proposed remedy is not.

An Alternative Capital Proposal

As an alternative to the proposed imposition of capital requirements greater than those on the underlying pool, ACB suggests that the more appropriate supervisory response to the problem of capital manufacture would be to unwind (at least temporarily) the booking of those profits into regulatory capital. Since these amounts are disclosed under GAAP, this adjustment would be straightforward. Under ACB’s proposal the maximum capital support for a retained residual would be set at the greater of: (a) the sum of the on-balance-sheet capital charge for the underlying pool of assets and the (after-tax) gain booked on the securitization, *less* the risk-based capital charges for the securitized tranches sold, or (b) the maximum legal exposure in any interests retained. It should be understood that this proposal is intended to be an alternative to both the dollar-for-dollar requirement and the required deduction from Tier 1 capital to avoid the doubling-up in the required capitalization of the affected residual positions that exists in the proposed rule.

Deductions From Tier 1 Capital

The proposed dollar-for-dollar capital requirement would require banks to hold capital equal to 100 percent of the balance sheet carrying value of their retained residuals. The additional proposed Tier 1 deductions would require them to hold incremental capital in excess of 100 percent. It is highly unlikely that the losses attributable to retained residuals could exceed their balance sheet value. Nevertheless, the proposed Tier 1 deductions would require a bank to hold incremental capital in excess of its loss exposure attributable to holding retained residuals.

To the extent that a final rule retains the approach of a dollar-for-dollar deduction from regulatory capital for excess residuals, it is clearly unnecessary to impose both an artificially high capital charge and its deduction from the ‘admitted’ capital amount. The alternative ACB has proposed of unwinding the booked gain seems more logical.

Net-of-Tax Treatment

Of course, either in the more coherent approach of unwinding the capital generated by the securitization transaction or in the approach adopted by the proposal, it is sensible to adopt the net of tax computation, at least as an option for the affected entity. It is conceivable that the occasional user of the securitization financial technology may seek to avoid the additional complexity of the net-of-tax calculation but it is essential to whatever logic underlies the regulatory solution to mitigate the capital impact to the extent of this significant net vs. gross distinction. In that event, it is also sensible to disallow the use of the associated deferred tax liability from use in the computation of any allowable net tax asset recognized for regulatory capital purposes; otherwise double-counting would be permitted.

Effective Date

Finally, either a purely prospective approach or a transition period of at least three years would be consistent with the approach that was suggested for the overall recourse initiative. To the extent that any individual entity presents immediate hazards that would not permit such a transition to the new regime, individual attention is indicated rather than an unduly burdensome general regulatory framework.

* * * * *

ACB has long taken a consistent position on the capitalization issues raised by the current proposal. The positions we have taken in these comments combine strong sympathy for the need to assure that risk exposures are appropriately covered with a real concern that any proposed capitalization rules be checked against the logic of internal coherence.

Thank you once again for this opportunity to reemphasize our concerns regarding this narrow, but important initiative. If you have any questions on the views expressed, please contact the undersigned at 202-857-3125.

Sincerely,


James E. O'Connor
Tax and Accounting Counsel