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November 16, 2000

Office of Thrift Supervision, Department of the Treasury  
Office of the Comptroller of the Currency, Department of the Treasury  
Federal Reserve System  
Federal Deposit Insurance Corporation

NOV 16 2000 10:28 AM

Re: Proposed Rule - "Capital; Leverage and Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Residual Interests in Asset Securitization or Other Transfers of Financial Assets" as published at 65 FR 57993 on September 27, 2000

Dear Ladies and Gentlemen:

Western Financial Bank (the "Bank") is pleased to have the opportunity to comment upon the referenced proposed capital rule (the "Proposed Rule").

**Overview of the Bank's Comments**

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (collectively, the "Agencies") have requested public comment on the Proposed Rule which substantially revises the regulatory capital rules for the treatment of residual interests. The Proposed Rule is designed to address a perceived risk concerning institutions that are holding inadequate capital against residual interests created upon the securitization or other transfer of financial assets in transactions treated as sales as defined by the Financial Accounting Standards Board Statement No. 125, "Accounting for Transfer and Servicing of Financial Assets and Extinguishment of Liabilities ("SFAS No. 125").

The Proposal Rule states that the Agencies are concerned with the general illiquid and volatile nature of residual interest assets. More directly, we believe that the Agencies do not want banks to leverage growth with non-cash capital created through the liberal application of SFAS No. 125 to the generation of I/O strips through non-cash gain on sale transactions. We agree with the Agencies concern over such a position on I/O strips. We do not agree, however, that the Proposal Rule is the best response to handle this concern.

The Proposed Rule imposes new and substantial capital obligations in an overly broad, punitive, one size fits all approach to cure perceived risks with residual interests. Additionally, the Proposed rule imposes excessive capital burdens on entities, such as the Bank, which have engaged in securitization transactions in full conformity with the guidance<sup>1</sup> previously announced by the agencies without differentiating between those risks which are directly due to the effect of a securitization from those risks which exist whether an asset is securitized or retained on balance sheet.

More specifically, the Proposed Rule applies an inconsistent capital requirement to those entities that account for securitization transaction as sales under SFAS No. 125 compared with those that account for securitization transaction as secured financings or use some other on-balance sheet financing structure. The Proposed Rule also creates an inconsistent approach to capital requirements as it fails to recognize the significant difference between the potential risk created from assumptions used to forecast an I/O strip versus the risk associated with other residual interests.

The Bank urges the agencies to not adopt any new capital rules but continue to utilize existing regulations relative to asset securitization that provides a more consistent approach. In addition to existing capital regulation, the agencies also have the regulatory power to require an institution to hold increased capital or conversely to reduce the amount of those assets that may be included in calculating the institution's capital compliance on a case by case basis if an institution is unable to demonstrate during the examination process that it has the expertise or systems to correctly calculate and monitor its non-cash gain-on-sale assets. The Bank, therefore, believes the agencies currently have in place the regulatory tools necessary to address any perceived risk that may arise at certain institutions that have applied liberal assumptions to the estimation of their I/O strips.

However, if the agencies disagree with this recommendation the Bank urges that no new capital rules be imposed upon residual interests which are not an I/O strip. Additionally, any new capital rules adopted with respect to non-cash I/O strips should either phase-out gain-on-sale accounting or phase-in the impact of the rules so that the affected institutions, to the extent each may then be required to raise capital externally, may do so in the most efficient manner possible.

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<sup>1</sup> Interagency Guidance on Asset Securitization Activities, December 13, 1999 (the "Securitization Guidance").

## **History of the Bank's Securitization Activities**

We have been consistently issuing automobile receivable asset-backed securities since 1985. We believe we were the first thrift to engage in the securitization of such assets. We are the largest seller of such securities, in aggregate dollar amount, after the United States captive auto finance companies, General Motors Acceptance Corporation, Ford Motor Credit Company and Daimler Chrysler Financial Company L.L.C. During the fifteen year period from 1985 through 2000, we have sold approximately \$19.0 billion of asset-backed securities in 50 transactions. The first issues was rated AA by Standard & Poor's Rating Service, a division of McGraw-Hill, Inc. ("S&P") and Aa by Moody's Investor Service, Inc. ("Moody's") and all 49 issues since that time were rated AAA by S&P and Aaa by Moody's, their highest rating categories, as a result of the structure of the transactions, the quality of the contracts securitized or the credit enhancement provided by a third party monoline insurance company.

In all of our securitization transactions, we, directly or through our operating subsidiary, WFS Financial Inc continued to service the contracts sold. Each transaction is independent of all others, with no cross-collateralization or cross-default provisions applicable. Of the 50 securitization transactions, 33 have been paid in full on or before their contractual maturity date. The remaining 17 transactions have not yet reached their contractual maturity date. Some of these transactions have been accounted for as secured financings while others have been accounted for as sales.

The Bank firmly believes that it has conducted its securitization activities in full compliance with the requirements of the Securitization Guidance even before the Securitization Guidance was released by the banking agencies. As a result, we have never taken a write-down of our I/O Strip nor has the securitization trustee for any of the transactions ever had to access the cash held in a spread account for a transaction or seek payment on any securities from the insurer for that transaction. We view the asset-backed securities market as a significant and profitable source of low cost financing for our institution. Accordingly, we believe our 15 years of highly successful experience in the asset securitization market makes us uniquely qualified to comment on this Proposal.

## **Discussion of the Issues**

Based upon the significance of the proposed rule, the Bank believes that it is important to describe in greater detail the issues that we have concerning the Proposed Rule.

### **Issue No. 1 - The Proposed Rule will discourage the use of securitization activities which provide significant benefits to the securitizing institution and the insurance funds.**

The Agencies should not discourage FDIC insured financial institutions from using securitization transactions as a means of funding. Securitization inherently creates an alternative source of liquidity, reduces the reliance on FDIC insured deposits to fund higher risk-weighted assets, reduces interest rate risk for fixed rate asset classes by matching the duration of the assets with the notes issued, and limits credit risk to the institution through insurance guarantees or other credit enhancement mechanisms.

A side by side comparison of three hypothetical institutions is instructive. The first institution, Company A, funds its assets primarily through insured deposits and retains the financial assets so acquired on balance sheet. The second institution, Company B, uses fixed rate asset securitization activities accounted for as sales under SFAS125 to fund its assets and recognizes gain-on-sale in connection with those activities. The third institution, Company C, uses fixed rate asset securitization activities treated as a financing to fund its assets and does not recognize gain-on-sale in connection with those activities. The attached pro-forma balance sheets show the effect of a catastrophic event as a result of which the financial assets in question suffer 10% losses. The result is that the affected institutions and the insurance funds are at most risk from the activities of Company A, less at risk from the activities of Company B and least at risk from the activities of Company C.

While this may be counter to the perceived risks which motivated the Proposed Rule, it is the correct result as Company A is in a first loss position as to 100% of its assets; Company B is in a first loss position only as to the gain-on-sale and other residual interests it has recognized in the securitization; and Company C is in a first loss position only as to the other residual interests it has recognized in the securitization. The lower an institution's total first loss exposure, the lower the risk to the insurance fund presented by that institution's balance sheet.

The following table summarizes the benefits of securitization.

	Company A Fund w/Deposits	Company B Fund w/Securitization Gain-on-sale	Company C Fund w/Securitization Secured Financing
Liquidity	Limited to Deposits	Deposits plus proceeds from securitization	Deposits plus proceeds from securitization
Ability to Pay Insured Depositors	Cash plus market value of loans	All Cash	All Cash
Credit Risk Profile	Unlimited	Limited to Credit Enhancement	Limited to Credit Enhancement
Interest Rate Risk Profile	Unlimited	Limited to the Clean-up Call	Limited to the Clean-up Call
Ability to Leverage Growth with non-cash gains	None	Depends on RISA Cash Flow assumptions	None

As the risk to an institution and to the insurance fund from securitization activities is less than holding assets on balance sheet, the existing capital rules, including the existing rules for recourse liabilities, are sufficient. We again note that to the extent the Agencies are concerned with potential abuse of non-cash gain-on-sale calculations from overly optimistic assumptions made by institutions that do not have the expertise in asset securitization to make appropriate calculations or to adequately monitor those non-cash assets or to conform their securitization activities to the Securitization Guidance, the Agencies have the authority to impose individual minimum capital requirements on those institutions.

**Issue No. 2 - The Proposed Rule assigns the same level of risk to different residual interests that have dramatically different risks.**

The Proposed Rule takes a one size fits all approach by treating all residual interests as though they each pose the same degree of risk to the institution holding those residual interests. Given that there are marked differences among the assets defined as residual interests by the Proposed Rule, this approach unfairly penalizes the institutions holding lower risk residual interests.

The single most significant difference among residual interests is the difference between non-cash gain-on-sale assets, primarily the I/O Strip, and cash based residual interests such as spread accounts and subordinated securities or retained portions of sold assets. The Agencies are correct in their concern that the value of an I/O Strip may be uncertain. The value is calculated based upon numerous assumptions, as reflected by the discussion in the Proposed Rule. The value that is calculated can be made to be quite high by using very optimistic assumptions, or can be made to be very low by using very conservative assumptions. The value is also subject to significant change in value if the assumptions used are modified after the value is initially set.

Conversely, residual interests in the form of spread accounts are actual cash collected by the institution temporarily held in trust for the investors in the securities, while residual interests in the form of subordinated securities and retained portions of sold assets are percentage interests in the actual underlying tangible financial assets that have been securitized or transferred. The value of these assets is their face amount and does not rely upon assumptions or complex calculations for determination. They are not subject to change in value based upon changes in assumptions.

Residual interests other than I/O Strips are no different than any other recourse liability that the capital regulations of the Agencies have well covered for many years. The Proposed Rule offers no rationale for treating these forms of recourse liability any different than any other form of recourse liability which the risk-based capital rules already address. Accordingly, even if any new capital rule is necessary for I/O Strips, no new capital rule is needed for these other residual interests.

**Issue No. 3 - The Proposed Rule will increase the cost of capital for institutions that securitize and put such institutions at a competitive disadvantage with non-regulated companies. Additionally, these institutions will be forced to pass the higher cost of capital to its customers.**

The clear intent of the rule is to impose on those institutions which securitize or otherwise transfer assets and as a result retain any residual interest, as defined by the Proposed Rule, to hold additional capital. The amount of additional capital which the Proposed Rule requires may be very large. An institution which must hold larger amounts of capital than the next institution of equal size is obviously able to deploy a lesser amount of its assets for the generation of income. The former institution also needs to earn higher income from its assets in order to have the same amount of income as the institution permitted to hold less capital (but which institution, as demonstrated above, may be at greater risk to the insurance fund).

This means that it must either charge more for its products or, more likely, focus its attentions on more risky financial assets as to which higher interest rates are expected. Regulations which have the unintended consequence of driving institutions to invest in higher risk financial assets are counter-productive and should be avoided.

Conversely by reducing the capital available to institutions that use securitization transactions, such institutions may be forced to discontinue offering certain products altogether, particularly to those borrowers who are of a higher credit risk profile. This will reduce the role of FDIC insured banks in providing credit to those who find credit most difficult to obtain. These prospective borrowers may end up paying higher interest rates to companies whose fair lending practices are not closely scrutinized.

**Issue No. 4 - The Proposed Rule applies inconsistent capital requirements for activities with similar risks.**

The risk presented to an institution and the insurance fund by the securitization of assets and the retention of a residual interest other than an I/O Strip is less than the risk to an institution continuing to hold financial assets on balance sheet. When an institution holds a financial asset it is at risk as to the entire asset, and that risk is a first loss risk. If the asset declines in value by 5%, 10% or 100%, the institution which holds that asset must write off the full amount of that loss.

Conversely, if an institution has securitized that financial asset and has retained a residual interest other than an I/O Strip, that institution will never record a loss greater than the amount of that retained interest. As the following chart reflects, if one institution securitizes \$100 million of loans and retains a 12% subordinated interest and another simply holds the \$100 million of loans on balance sheet, the risk to the insurance fund is greater from the institution that holds the loan assets. The institution which has securitized its assets may suffer a loss in excess of the capital it holds, but the institution that does not securitize will also suffer a loss in excess of the capital it holds, and that institution's loss may, in a catastrophic situation, be many fold greater.

	<b>Holds Loans</b>	<b>Holds 12% Subordinated Interest</b>
<b>Asset held</b>	\$100 million	\$12.0 million
<b>Risk of loss</b>	Unlimited	\$12.0 million

As the risk to the insurance fund from residual interests other than I/O Strips is less than that presented by holding the securitized assets on balance sheet, consistent application of the capital rules would dictate that more capital be held by institutions that do not securitize rather than as proposed, by institutions that securitize and hold residual interests other than I/O Strips.

**Issue No. 5 - The Proposed Rule ignores the right of offset of liabilities relating to certain residual interests.**

Certain institutions have access to the cash flows of each of its outstanding securitization transactions, including the cash held in each spread account through various securitization agreements. These agreements permit such institutions to use that cash as it determines, including in the ordinary business activities of the institution. In order to show the obligation to the securitization trust, the institution's balance sheet is grossed up to show both this requirement and the inherent restriction to those funds if a catastrophic event were to occur. To the extent that cash relating to residual interests are held by an institution, the institution should have the right to offset the residual interest asset with the corresponding residual interest liability.

**Issue No. 6 - The Proposed Rule does not clearly define the right of offset for deferred tax liabilities.**

The Proposed Rule permits a net of deferred tax treatment for both the amount of residual interests that are disallowed residual interests (amount in excess of the 25 percent of Tier 1 capital sublimit) as well as the remaining residual interests subject to the dollar-for-dollar capital requirement based upon existing deferred tax liabilities associated with such assets. By allowing a net of tax treatment only for existing deferred tax liabilities, the proposed rule will provide a benefit to institutions whose tax and accounting methods for the timing of income are different. The tax treatment should be irrelevant to capital consequences and the associated tax liability should be netted against the asset in all cases.

The Proposed Rule does not consider that if residual interests were truly written off for book purposes as proposed by this rule, a deferred tax liability would be created for the full amount of the write-off based upon the institution's corporate tax rate. We request that the Proposed Rule, if implemented, be modified to reduce all residual interests amounts deducted from capital by calculating an estimated deferred tax liability based upon applying the institution's corporate tax rate to the full balance of the residual interests.

**Issue No. 7 - The Proposed Rule does not provide institutions the ability to either grandfather existing transactions or a transition period to raise additional capital, if needed.**

The Bank is firmly of the view that the insurance fund is best protected by not adopting the Proposed Rule in any form. Certainly, if any new capital rule is adopted, it should not require any increased capital with respect to residual interests which are not I/O Strips. However, if any version of the Proposed Rule is adopted, fundamental fairness to those institutions which have engaged in securitization or other transfers of financial assets and have retained residual interests, as defined in the Proposed Rule, requires that their historical activities be either grandfathered or that they be provided with a transition period to raise the needed additional capital.



An institution may need to raise if the Proposed Rule were to be adopted as drafted. The fair market value of property, including an institution seeking to raise capital, is the product of parties who are not acting under duress. When an institution is seeking to raise substantial new capital, whether as equity capital or subordinated debt securities, because it must do so in a very short time to avoid serious adverse regulatory consequences, that institution is acting under duress. The capital markets will be aware of this situation and the likelihood is that the institution will not get the same efficient result that it would get if it were seeking to raise capital while not under the same obligation to do so. While the institution is unable to quantify the effect of that loss of efficiency, it is likely to be more than a nominal amount.

In addition, to the extent an institution has engaged in securitization activities in conformity with the Securitization Guidance and are otherwise not problem institutions, its residual interests should be either grandfathered or it should be permitted a transition period so that it can access the capital markets in a more orderly manner in order to raise that needed capital in the most efficient manner possible. After all, the more capital that can be raised at the lowest cost possible to the institution is also best for the insurance fund.

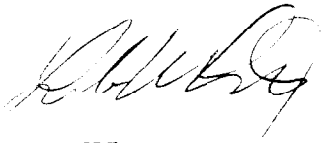
### **Recommendation**

Based upon the foregoing discussion of the relevant issues, we believe that the Proposed Rule should be withdrawn. The Agencies existing recourse capital rules, Securitization Guidance and individual minimum capital regulations are adequate to police the few institutions that may engage in securitization activities without being fully aware of the risks associated with those activities or which are being too aggressive in their non-cash gain-on-sale calculations.

Moreover, as the risks associated from holding assets on balance sheet is greater, especially in times of dramatic losses, than from securitizing those assets and holding residual interests other than I/O Strips, there should be neither new capital charges for such assets nor any limitation in the amount of those assets as might be included in a financial institution's capital. Finally, if any new capital rules are adopted, they should either contain grandfather provisions or transition provisions to avoid unduly penalizing institutions that have complied in their securitization activities with the Securitization Guidance.

We would be pleased to amplify any of our comments, at your request. We thank you for your consideration of our views.

Very truly yours,

A handwritten signature in black ink, appearing to read 'Lee A. Whatcott', written in a cursive style.

Lee A. Whatcott,  
Senior Executive Vice President and  
Chief Financial Officer,  
Western Financial Bank

<b>Company A - FDIC Insured Deposit Term Funding</b>
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Balance Sheet:

	<u>Period 1</u>	<u>Period 2</u>	<u>Period 3</u>	<u>Period 4</u>
<b>Assets</b>				
Cash	12	15	15	60
Loans	100	100	90	0
Allowance	-2	-2	0	0
Interest only strips				
Credit enhancement asset				
<b>Total Assets</b>	<u>110</u>	<u>113</u>	<u>105</u>	<u>60</u>
<b>Liabilities</b>				
Deposits	100	100	100	100
Secured financings				
<b>Equity</b>				
Paid in capital	10	10	10	10
Retained earnings		3	-5	-50
<b>Total Equity and Liabilities</b>	<u>110</u>	<u>113</u>	<u>105</u>	<u>60</u>
Capital ratio	7%	9%	3%	0%

**Period 1:**

Funds \$100 of loans with deposits  
 Establishes 2.0% allowances  
 Meets capital requirements

**Period 2:**

Earns net spread of \$3

**Period 3:**

Catastrophic event - 10% losses on loans or \$10

**Period 4:**

In order to satisfy deposit holders, the institution would be required to sell its loans. Because the portfolio has experienced a catastrophic loss of 10%, the portfolio would be sold at a discount. In this example the discount is 50%. In order to pay depositors, the discount on this portfolio would need to be no less than 94%, which would be unlikely given the high loss rate. Therefore, funds would not be available to pay depositors as the institution bears the full risk of losses.

**Conclusion:**

Institution is in a first loss position for 100% of the loans  
 Cash is insufficient to pay depositors, FDIC insurance fund must pay the deficiency

Note: In order to keep the example simple, we did not include the effect of taxes. The impact of taxes is discussed in detail in our letter.

<b>Company B - FDIC Insured Seller of Loans through securitizations</b>
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Balance Sheet:

	Period 1	Period 2	Period 3	Period 4
<b>Assets</b>				
Cash	12	105	105	105
Loans	100	0	0	0
Allowance	-2	0	0	0
Interest only strips		6	0	0
Credit enhancement asset		10	0	0
<b>Total Assets</b>	<b>110</b>	<b>121</b>	<b>105</b>	<b>105</b>
<b>Liabilities</b>				
Deposits	100	100	100	100
Secured financings				
<b>Equity</b>				
Paid in capital	10	10	10	10
Retained earnings		11	-5	-5
<b>Total Equity and Liabilities</b>	<b>110</b>	<b>121</b>	<b>105</b>	<b>105</b>
Capital ratio	7%	14%	3%	0%

**Period 1:**

Funds \$100 of loans with deposits  
 Establishes 2.0% allowances  
 Meets capital requirements

**Period 2:**

Earns net spread of \$3  
 Sells \$100 in loans through securitization transaction  
 Records estimated gain on sale and I/O Strip of \$6, which leverages capital levels  
 Advances 10.0% funds for credit enhancement or \$10

**Period 3:**

Catastrophic event - 10% losses on loans sold  
 Credit enhancement asset is written-off since no repayment will be made  
 I/O strip is written-off estimated cash flows will no longer be received

**Period 4:**

Institution holds cash from sale of loans which can be used to pay depositors

**Conclusion:**

Institution is in a loss position only up to the amount of the credit enhancement  
 The risk of loss above the credit enhancement has been transferred to the investors of the notes  
 Cash is sufficient to pay depositors, FDIC insurance fund is safe

Note: In order to keep the example simple, we did not include the effect of taxes. The impact of taxes is discussed in detail in our letter.

<b>Company C - FDIC Insured Secured Financing Securitization</b>
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Balance Sheet:

	Period 1	Period 2	Period 3	Period 4
<b>Assets</b>				
Cash	12	115	115	105
Loans	100	100	90	0
Allowance	-2	-2	0	0
Interest only strips				
Credit enhancement asset				
<b>Total Assets</b>	<b>110</b>	<b>213</b>	<b>205</b>	<b>105</b>
<b>Liabilities</b>				
Deposits	100	100	100	100
Secured financings		100	100	0
<b>Equity</b>				
Paid in capital	10	10	10	10
Retained earnings		3	-5	-5
<b>Total Equity and Liabilities</b>	<b>110</b>	<b>213</b>	<b>205</b>	<b>105</b>
Capital ratio	7%	9%	3%	0%

**Period 1:**

Funds \$100 of loans with deposits  
 Establishes 2.0% allowances  
 Meets capital requirements

**Period 2:**

Earns net spread of \$3  
 Sells \$100 in loans through securitization transaction  
 Records notes payable

**Period 3:**

Catastrophic event - 10% losses on loans

**Period 4:**

Institution is under no obligation to pay note holders beyond the credit enhancement of 10%.  
 Institution holds cash from sale of loans which can be used to pay depositors

**Conclusion:**

Institution is in a loss position only up to the amount of the credit enhancement  
 The risk of loss above the credit enhancement has been transferred to the investors of the notes  
 Cash is sufficient to pay depositors, FDIC insurance fund is safe

Note: In order to keep the example simple, we did not include the effect of taxes. The impact of taxes is discussed in detail in our letter.