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2000 DEC 18 P 3:43

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December 12, 2000

Office of the Comptroller of the Currency
Communications Division, Third Floor
250 E Street, SW
Washington, DC 20219

Board of Governors of the Federal Reserve System
Ms. Jennifer J. Johnson, Secretary
20th Street and Constitution Avenue, NW
Washington, DC 20551

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

✓Office of Thrift Supervision
Manager, Dissemination Branch
Information Management and Services Division
1700 G Street, NW
Washington, DC 20552

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
OCC Docket No. 00-17
Board Docket No. R-1080
OTS Docket No. 2000-70

Dear Ladies and Gentlemen:

As counsel, we have represented financial institutions in numerous asset securitization transactions and also in connection with matters of capital adequacy and capital raising activities. We are submitting our comments to the referenced proposed rule based upon our experience derived from that representation.

INTRODUCTION TO COMMENTS:

The federal bank regulatory agencies[1] have determined that financial institutions are at risk with respect to certain assets they hold which have arisen upon the securitization or other transfer of financial assets by those institutions. That determination has resulted in the publication for comment of the referenced proposed rule (the "Proposal"). The Proposal seeks to amend existing capital regulations to require that substantially more capital be held by an institution which securitizes or otherwise transfers financial assets than must be held by that institution if it does not securitize or transfer those financial assets. The Proposal should not be adopted as drafted as the Proposal will impose an overly broad, punitive, one size fits all solution to the problem perceived by the Agencies. The Proposal punishes those entities which have engaged in securitization transactions in full conformity with the Interagency Guidance on Asset Securitization Activities dated December 13, 1999 (the Guidance) and it does not differentiate between those risks which are directly due to the effect of a securitization from those risks which exist regardless of whether an asset is securitized or retained, unsold, on balance sheet. The Agencies are also acting prematurely, without giving enforcement of the Guidance through the examination process and the imposition, where appropriate, of individual minimum capital requirements[2] tailored to the specific circumstances of the affected institution an adequate opportunity to sufficiently reduce the risk to the affected institution, the banking system and the insurance fund.

DISCUSSION:

A. Residual Interests other than Non-Cash Gain-on-Sale Assets

The proposal focuses upon two general categories of risk. The first is the risk associated with an institution's recourse liability as to the transferred assets, whether by way of subordinated securities, retained portions of the transferred assets or other residual interests which act as credit enhancement of the assets transferred. The second is the risk arising from application of FAS 125 and the non-cash gain-on-sale asset created and booked as a result of the sale of financial assets in a securitization transaction or other transfer. While the non-cash gain-on-sale asset is within the definition of "residual interest" included in the Proposal, the characteristics of that asset warrants separate discussion of it in Part B of this Discussion. The discussion in this Part A is limited to residual interests other than non-cash gain-on-sale assets

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[1] The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision, herein referred to jointly as the "Agencies".

[2] See, *e.g.*, OTS Regulation 12 CFR §567.3.

(such as subordinated securities, retained portions of assets sold, spread accounts or cash collateral accounts).

The Proposal (1) fails to adequately differentiate between the risks associated with holding those other residual interest assets from the risks associated with holding non-cash gain-on-sale assets and (2) over emphasizes the risks to an institution's balance sheet derived from holding such residual interests as compared to the risks of holding the underlying financial assets if a securitization or other transfer had not occurred. As a result, the Proposal is overly broad and imposes punitive new capital requirements grossly out of proportion to the risks actually present with respect to these other residual interests.

1. The Value of Other Residual Interest Assets Are Not Speculative or Subject to Abuse

Unlike non-cash gain-on-sale assets which are a creature of GAAP, specifically FAS 125, the value of which are the result of the interplay of several subjective decisions, the value of these other residual interests are fixed amounts objectively determined. The face value of a subordinated security or of a retained portion of a sold asset is the amount of that asset. Spread accounts[3] and cash collateral accounts are composed of cash actually collected and temporarily trapped in the spread account or cash collateral account. Since the value of these assets is based upon an actual tangible asset, their valuation is not subject to abuse or conjecture as is the case with non-cash gain-on-sale assets. Hence, these assets should not be treated the same as non-cash gain-on-sale assets to the extent the Proposal is motivated by (1) uncertainties as to valuation or (2) the potential for value to be greatly overstated by applying excessively liberal assumptions.

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[3] In this letter, when speaking of spread accounts we are referring to an account created upon the securitization of financial assets through which excess cash collected from the securitized assets flows and which account is used to credit enhance the securitization transaction. Typically, the spread account is prefunded at closing of the securitization with cash in an amount equal to an agreed percentage of the assets securitized. The maximum size of the spread account is also set at an agreed percentage of the principal of the outstanding securitized assets. To the extent amounts are collected from the obligors on the underlying financial assets in excess of the amounts periodically due on the securities issued, that "excess spread" is deposited into the spread account. As the excess spread is ultimately the property of the institution which has securitized the assets and retained the right to that excess spread, GAAP requires that the excess spread be recorded as income when deposited into the spread account. When the amounts accumulated in the spread account reach the then applicable percentage limit, any accumulated amounts in excess of that limit are distributed, without recourse, to the institution. The amounts in the spread account are at risk while in the spread account because GAAP requires that they be treated as earned when deposited therein, rather than when released from the spread account.

2. *The Risks of Holding Other Residual Interest Assets is Less Than the Risk of Holding Financial Assets*

Other retained interest assets do not, on balance, suffer the abnormal risks asserted in the Proposal when compared to the risks arising from retaining the financial assets on balance sheet. For instance, assume an institution holds $100 million of 100% risk-weighted financial assets on its balance sheet. It will hold $8 million of capital against those assets. If it does not securitize those assets, it alone is 100% at risk of loss if those assets fail to perform. The institution holding those financial assets is in a first loss position as to the full amount of those financial assets.

However, if that same institution sells the assets at par and creates an 6% spread account, it will receive $100 million of cash and will have not more than $6 million in a spread account, even assuming it fully funds the spread account at the inception of the securitization transaction.[4] Even in the case of an initially fully funded spread account of $6 million, the maximum risk to the securitizing institution with respect to the spread account residual interest asset is $6.0 million, the amount on deposit in that account. As the underlying automobile receivables are collected the size of the spread account will be reduced and with it the risk from holding the spread account residual interest asset.

The following charts reflects the reduction in risk resulting from securitizing assets and holding a spread account residual interest asset as compared to just holding the underlying financial assets. Chart 1 assumes losses are suffered immediately after a securitization transaction commences and reflects the differential in losses based upon $100 million of financial assets and a 6% spread account fully funded at inception. Chart 2 assumes losses are suffered at the time the spread account becomes fully funded and reflects the differential in losses based upon $100 million of financial assets and a 6% spread account which is initially pre-funded at 3% and grows to its maximum size of $3.6 million when the outstanding financial assets have been amortized down to $60 million.

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[4] We note that typically a spread account is not fully funded at closing of a securitization transaction. Generally, for example, a 6% spread account may be initially funded to the extent of 2% to 4% of the principal amount of the financial assets securitized. In a typical automobile receivable securitization transaction, the spread account would be expected to reach 6% of the outstanding principal of the securitized automobile receivables in about 14 months, by which time the outstanding principal will have amortized down to about $60 million in our $100 million hypothetical. Hence, the spread account would be expected to build to a maximum size of $3.6 million (6% of $60 million) and thereafter amortizing down as the principal of the automobile receivables continue to be paid down.

Chart 1

Loss Rate	Dollar Loss		Additional Loss
Scenarios	**Holding**	**Securitizing**	**From Holding Loans**
3%	$3 million	$3 million	none
6%	$6 million	$6 million	none
10%	$10 million	$6 million	$4 million
20%	$20 million	$6 million	$14 million
50%	$50 million	$6 million	$44 million

Chart 2

Loss Rate	Dollar Loss		Additional Loss
Scenarios	**Holding**	**Securitizing**	**From Holding Loans**
3%	$1.8 million	$1.8 million	none
6%	$3.6 million	$3.6 million	none
10%	$6 million	$3.6 million	$2.4 million
20%	$12 million	$3.6 million	$8.4 million
50%	$30 million	$3.6 million	$26.4 million

The foregoing charts reflect that securitization and holding the spread account residual interest asset exposes the selling institution and the insurance fund to less risk than not securitizing. Indeed, to the extent the Agencies are concerned with the adverse consequences of unstable economic circumstances, these charts reflect that institutions which securitize and hold spread account residual interest assets are much better protected from catastrophic losses than institutions which do not securitize.

In our hypothetical, the securitizing institution would hold dollar for dollar capital under the low level recourse rule in an amount equal to the cash in the spread account (between $3.6 to $6 million in our examples). The institution holding the loans on balance sheet would hold no more than $8 million of capital against these 100% risk-weighted assets. As loan quality deterioration accelerates, the institution which securitized would have to write off the amount in the spread account. It would be holding capital to fully cover that loss under the existing capital rules. The institution holding the loans on balance sheet would be required to write off the full amount of the loss and to the extent the loss exceeds 8% of the outstanding principal of the loans would be holding inadequate capital under the existing capital rules.

As the discussion of this hypothetical demonstrates, the risk to an institution presented by its holding cash trapped in a spread account is no greater, and is in many cases far less, than the risk of not having securitized the loans and creating the spread account. As

the risk presented by holding a residual interest in the form of cash trapped in a spread account is less than the risk flowing from never having sold the loans, the capital burden on an institution from holding a spread account residual interest asset should be no greater than holding an unsold loan.

The analysis is the same for other residual interest assets that are not non-cash gain-on-sale assets, whether the other residual interest asset is a cash collateral account, a subordinated security or a retained portion of a sold asset. In each case an institution is at 100% first loss risk if the financial asset it holds is not sold. When it securitizes or otherwise transfers its financial assets and retains recourse liability via any of these other means its residual interest is at risk, but to no greater degree than if it had not sold the assets to begin with.[5]

3. Existing Capital Regulations and the Guidance are Adequate

The banking Agencies existing recourse rules[6] are fully adequate to protect the integrity of the banking system and the insurance funds from the potential losses which these other retained interest assets may present. A retained interest asset of the type involved here is at risk only if the financial assets which were sold suffer substantial losses. The institution which continues to hold those financial assets will also suffer those losses, but is at risk of losing even more capital if the assets continue to deteriorate. There is no justification, given these realities, to force an institution which has securitized and has thereby limited its losses to the amount of retained recourse to hold substantially more capital than the institution which has not sold those assets and is, therefore, at 100% first loss risk as to the full amount of all of the financial assets it owns.

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[5] For instance, assume an institution issues $100 million of asset-backed securities, selling $94 million of senior securities and retaining $6 million as subordinated securities. The selling institution will hold $6 million of capital under the low level dollar for dollar recourse capital rules. If the securitized loans deteriorate with losses at a 10% level, the institution holding the subordinated securities will suffer a $6 million loss, equal to the capital it holds, but no more. Had the assets not been securitized, the institution would have held $8 million of capital, but would incur a $10 million loss, $2 million in excess of the capital it was holding.

[6] See, *e.g.*, OTS Regulation 12 CFR §567.6(a)(2)(C) which already requires dollar for dollar capital for such recourse liabilities up to the amount of capital which would have to be otherwise held had the financial assets not been sold. The individual minimum capital regulation, 12 CFR §567.3, is also applicable to the extent an institution has acquired such recourse liabilities with respect to significant quantities of low quality assets or lacks management capable of adequately valuing or monitoring such assets.

Similarly, there is no justification to limit the amount of these other retained interests which may be included in capital. These other retained interest assets will lose value only if the underlying financial assets deteriorate sufficiently in quality, but when those financial assets do deteriorate the institution holding them on balance sheet is at even greater risk. *See*, Chart 1 and Chart 2. An institution which owns a substantial quantity of any particular financial asset is not required to hold more capital merely because it owns more of a particular type of financial asset than another similar sized institution which holds a lesser dollar amount of that type of financial asset. An institution which engages in significant amounts of securitization and ownership of these other types of residual interest assets should, likewise, not be obligated to hold more capital, especially when the risk to the institution's capital is less than if it had not securitized.

When the comparative risks between holding financial assets or securitizing them and retaining recourse in the form of these other retained interest assets are fairly analyzed, it is clear that the present Proposal is overly broad in including these other retained interests within its scope. These other retained interests should be fully deleted from the proposed regulation and should be dealt with using the existing recourse and individual minimum capital regulations already available to the banking Agencies.[7]

B. <u>Non-cash gain-on-sale Assets</u>

The Proposal correctly notes that when a financial asset is securitized in a transfer accounted for as a sale the selling institution is required, by reason of FAS 125, to book as an asset its non-cash gain-on-sale from the sale of the financial assets being

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[7] We note that the Proposal at footnote 4, 65 FR at 57995, and the text to which that footnote relates, states that the Proposal pertains only to residual interest assets created upon the sale of financial assets treated as sales under GAAP. However, it is not uncommon for a spread account, a cash collateral account or a subordinated interest to be created in connection with a securitization or other transfer accounted for as a financing. In those cases, however, as the footnote reflects, the securitization treated as a financing does not remove any assets from the institution's balance sheet and the full usual capital remains held against the financial assets securitized. To the extent these other retained interests are included in a final rule, the Proposal should be amended to more explicitly state that any residual interest created in connection with a securitization accounted for as a financing is not a "residual interest" for purposes of this rule. Absent that clarification, an institution runs the risk of being subject to double capital requirements, once for the financial assets which are being fully retained on the institution's balance sheet and again because it is also holding a residual interest which has arisen in connection with a transfer of an asset (the transfer to the securitization trust, albeit in a manner which precludes treatment of the transfer as a sale). The better result remains the deletion of all such other residual interests from the Proposal for the reasons discussed.

securitized. The very real problem facing the Agencies is that calculation of non-cash gain-on-sale is as much a qualitative exercise as it is a quantitative one. The amount of non-cash gain-on-sale recognized is the result of applying several assumptions regarding the financial assets including future performance of the underlying debtors, performance of the selling financial institution when it is the servicer of the sold assets and the economy in general. Being inadequately conservative can result in a large non-cash gain-on-sale which may have to be written down if future performance does not live up to the assumptions made at the time the non-cash gain-on-sale asset was created and booked.

1. The Guidance Has Not Been Given an Adequate Opportunity

Because subjective analysis is involved in the calculation of non-cash gain-on-sale, abuse and inaccuracy are possible. However, the Agencies have adopted the Guidance for the express purpose of ensuring that institutions which engage in securitization activities and are booking significant amounts of non-cash gain-on-sale assets are calculating the value of that non-cash gain-on-sale asset in a sufficiently conservative manner, monitoring those assets adequately and demonstrate the necessary expertise to engage in such activities in a safe and sound manner. The Proposal contains no evidence that the financial institutions which have complied with the Guidance are at greater risk as a result of their securitization activities than those which have not securitized similar financial assets held on balance sheet. Before adopting regulations which may result in substantial elimination of capital at institutions which have acted in conformity with the Guidance and are at this time well capitalized institutions, the Agencies should at least have some empirical evidence to the effect that well capitalized institutions complying with the requirements of the Guidance are at an increased risk of loss from their non-cash gain-on-sale assets.[8]

Further, the remedy in the Proposal is draconian, as it imposes substantial new regulatory obligations on institutions which have not themselves engaged in the overvaluation of non-cash gain-on-sale assets. Unless the Agencies are now taking the position that any non-cash gain-on-sale asset, regardless of how carefully and conservatively it is calculated, is untrustworthy, there is no rational basis to require dollar for dollar capital against all such assets. Similarly, there is no justification to require all institutions which hold those assets to limit the quantity of those assets that may be included in calculating the institution's capital compliance. Of course, if an institution is unable to demonstrate during the examination

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[8] We note that to avoid acting contrary to 5 USC §706(2)(A), there must be a rational connection between the facts considered by an agency and the choice it makes in the rules it adopts. *Motor Vehicle Manufacturers Ass'n* v. *State Farm Mutual Insurance Co.*, 463 U.S. 29, 43, 103 S.Ct. 2856, 2866-67 (1983). Losses occasioned by fraud or activities not in conformity with the Guidance do not support the imposition of higher capital obligations on institutions which are complying with the Guidance and whose managers are honest.

process that it has the expertise or systems to correctly calculate and monitor its non-cash gain-on-sale assets, the Agencies should require that institution to hold increased capital or conversely to reduce the amount of those non-cash gain-on-sale assets that may be included in calculating the institution's capital compliance. The Agencies already have that regulatory power such that the present Proposal is not necessary.

2. Non-Cash Gain-On-Sale Accounting Should be Phased-Out in Lieu of Imposing Burdensome New Capital Obligations

If the Agencies are firmly convinced that all non-cash gain-on-sale assets are so volatile that substantial risk will always exist as to those assets regardless of how conservatively the non-cash gain-on-sale asset is calculated, and regardless of how much expertise the institution engaged in securitization activities may have, then the more direct approach is to simply eliminate non-cash gain-on-sale accounting for regulatory capital purposes. If no non-cash gain-on-sale will be recognized upon a securitization or other transfer of financial assets, the securitization will not occur merely to create non-cash gain-on-sale assets. If no non-cash gain-on-sale assets will be recognized for regulatory purposes, capital will not be at risk from such assets, regardless of their quantity or quality. The immediate elimination of non-cash gain-on-sale accounting for regulatory capital purposes coupled with a five year phase-out of non-cash gain-on-sale assets already on an institution's balance sheet will eliminate future risk while not unduly penalizing those institutions which have relied upon existing regulatory capital and accounting rules in connection with their securitization activities.[9]

3. Any New Regulations Increasing Capital Requirements for Residual Interests Should be Phased-In

Finally, if the Proposal is adopted with respect to non-cash gain-on-sale assets as currently presented, the full impact of the Proposal should be phased-in over a minimum of five years in order to avoid unduly penalizing well capitalized institutions which hold a substantial amount of non-cash gain-on-sale assets. Institutions which have engaged in a significant amount of securitization activities and have calculated their non-cash gain-on-sale assets in a safe and sound manner, *i.e.*, in a manner consistent with the Guidance, should not be required, immediately, on the effective date of the Proposal, to comply with the Proposal as drafted.

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[9] As previously noted, the individual minimum capital rules would remain available as to any institution which did not comply with the Guidance in monitoring its grandfathered non-cash gain-on-sale assets during the phase-out period.

It is quite possible that several institutions which are currently well or adequately capitalized and are operating in every other respect in full conformity with the Guidance will find that as a result of the rules contained in the Proposal that they will be undercapitalized or will need to raise additional capital to remain well capitalized. It is fundamentally unfair to impose on such an institution the obligation to immediately raise substantial new capital to remain well capitalized, especially as the Guidance itself has only been in effect for less than a year. Thus, even institutions which recognized as a result of the Guidance that new capital obligations may be forthcoming and ceased engaging in transactions pursuant to which a non-cash gain-on-sale asset would be created, have not had an opportunity to amortize off those non-cash gain-on-sale assets or otherwise access the capital market to raise the requisite capital. Moreover, an institution will surely have an easier time raising capital if it can chose when to do so rather than being compelled to do so due to new and onerous regulations.

A phase-in of the full impact of the Proposal will permit the affected institutions to reduce the amount of the non-cash gain-on-sale assets held by them through their natural amortization and will permit those institutions to access the capital markets in a more orderly fashion, including as to timing and type of capital. Of course, if during the phase-in period an Agency determines that any given institution for which it is responsible is not acting in a safe and sound manner with respect to either its non-cash gain-on-sale assets or with respect to raising the capital it will need by the end of the phase-in period, that Agency has the express power to address that situation.

CONCLUSION:

Comparing the risks from not securitizing financial assets to the risks arising from securitizing financial assets and retaining residual interests (other than non-cash gain-on-sale assets) reflects that the risks to the affected institutions, the banking system and the insurance funds is already well addressed by the existing recourse capital rules, the Guidance and the authority of the Agencies to impose individual minimum capital requirements in appropriate situations. Therefore, the Proposal is unnecessary and punitive to the extent it deals with residual interests other than non-cash gain-on-sale assets, especially when those other residual interests are held by well capitalized institutions whose securitization activities are in compliance with the Guidance.

With respect to non-cash gain-on-sale assets, the Proposal is overly broad as it sweeps all institutions, including well capitalized institutions whose securitization activities are in full compliance with the Guidance under the same rigid rule. To the extent the existing tools available to the Agencies are not adequate to permit the Agencies to eliminate the risks to the banking system and the insurance fund posed by non-cash gain-on-sale accounting, the better approach would be to eliminate non-cash gain-on-sale accounting for regulatory

accounting purposes and to phase-out the amount of non-cash gain-on-sale assets currently held by institutions.

In any event, in order to limit the adverse impact of the Proposal if it is adopted as drafted, especially to those well capitalized institutions whose securitization activities are in compliance with the Guidance, the additional capital requirements should be phased-in so that no currently well capitalized institution will be forced to seek additional capital under threat of adverse regulatory action. Institutions required to raise their level of capital to off-set the affect to them of the Proposal should be permitted adequate time to acquire that new capital in the most efficient means possible.

We thank you for your consideration of our comments on the Proposal.

Very truly yours,

Andrew E. Katz
of
MITCHELL SILBERBERG & KNUPP LLP

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