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February 2, 1998

Communications Division, Third Floor
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219
Attention: Docket No. 97-22

Mr. William Wiles
Secretary
Board of Governors of the Federal Reserve System
Federal Reserve Board
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
Attention: Docket No. R-0985

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

Manager, Dissemination Branch
Records Management and Information Policy
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552
Attention: Docket No. 97-86

Re: Risk-Based Capital Standards: Recourse and Direct Credit Substitutes

Ladies and Gentlemen:

The Bond Market Association1 (the "Association") welcomes the opportunity to comment on proposals2 issued by the constituent agencies (the "Agencies")3 of the Federal Financial Institutions Examination Council ("FFIEC") that would revise their risk-based capital standards to address the regulatory capital treatment of recourse obligations and direct credit substitutes that expose banking organizations to credit risk. Overall, the Association views the proposals as a positive step toward achieving a more consistent, rational and efficient regulatory capital framework for banking organizations, and commends the Agencies for their continuing initiatives in this area.

The Association's membership includes banks and securities firms that are active in a wide range of asset securitization activities.4 Our bank members are directly impacted by these proposals, since they are both users and providers of recourse and direct credit substitutes, through transfers of assets and the provision of credit enhancement in connection with asset securitizations. Our broker-dealer members are also impacted by the proposals, as providers of investment banking, securities underwriting and distribution services to banks and other organizations that are engaged in asset securitization activities. From a broader market perspective, banking organizations are also major institutional investor participants in the asset-backed securities markets.5 Accordingly, the regulatory capital treatment of recourse arrangements and direct credit substitutes significantly impacts the depth and liquidity of those markets.

Given the relevance of these issues to our membership, the Association has a longstanding and continuing interest in regulatory capital proposals issued by the FFIEC, having most recently commented extensively on the Agencies' 1994 proposals concerning the treatment of recourse and direct credit substitutes.6 In many respects, we regard the current proposals as a material advancement beyond the 1994 proposals, and a significant improvement over the status quo. Our comments do not purport to address all aspects of the proposals, or to respond in detail to each of the specific questions contained in the Release. Instead, we wish to offer several general comments concerning what we believe to be the appropriate evolution and further development of regulatory risk-based capital requirements for asset securitizations. We also wish to provide our views and recommendations in response to several specific proposals set forth in the Release.

I. GENERAL COMMENTS

The Association applauds the philosophical approach and goals embodied in the Release. In particular, we concur with the Agencies' views that:

1. Capital requirements should more closely reflect a banking organization's relative exposure to credit risk; and

2. Whatever form a recourse obligation or direct credit substitute may take, the same amount of capital should be required for arrangements that expose a banking organization to an equivalent risk of loss.

Securitization-the process of converting illiquid assets and future cashflow streams into capital market instruments-has become an increasingly important financing technique in the United States, as well as abroad. Banking organizations participate broadly in this process, serving variously as issuers, credit enhancers and investors in a wide range of mortgage-backed and asset-backed securities transactions.

As issuers, securitization offers banking organizations a highly efficient mechanism for financing their continuing operations. They accomplish this by liquidating and realizing the present economic value of assets held in their portfolios, thus replenishing the supply of funds from which additional loans may be made, while simultaneously shifting interest rate risk, liquidity risk and credit risk to investors. As credit enhancers, banking organizations seek economic benefits by engaging in a profitable line of business that draws upon their basic organizational strength and expertise-performing detailed credit analysis and making informed judgments about the quality and expected performance of assets underlying securitization transactions.7 As investors, banking organizations benefit in the same manner as other institutional investors from the investment characteristics afforded by asset-backed securities. Among others, these characteristics include attractive yields, high credit quality, diversification opportunities and the ability to target maturities in a manner that contributes to the achievement of duration management and asset-liability management goals.

The Association agrees with the Agencies' basic premise that the current risk-based capital framework is flawed, in that it does not vary the rate of capital assessment with differences in credit risk represented by different types of recourse arrangements, direct credit substitutes, and other positions banking organizations may take in asset securitization transactions. In addition, we do not believe that the Agencies' current framework-and as discussed herein, certain aspects of its proposed modifications to that framework-give sufficient credit to the risk reduction benefits that securitization activities make possible for individual institutions, and for the banking system as a whole.

The Association generally endorses the Agencies' proposed ratings-based, multi-level approach that would directly link capital requirements and levels to the rating assigned to a particular asset securitization position. We believe that such an approach, with several important refinements, would provide banking organizations with an improved, more efficient regulatory capital framework. It would also afford them far greater flexibility than they now enjoy in managing their credit exposure through various investments, credit enhancement activities and securitization strategies.

However, the Association strongly recommends that the Agencies, in addition to adopting and promptly implementing a ratings-based, multi-level approach, simultaneously pursue other modifications to their current regulatory risk-based capital framework. Principally, these modifications should include the implementation of internal information, bank model approaches to determine a banking organization's individual capital requirements. These approaches should be made available as a supplement or replacement to the ratings-based approach. We believe that these internal information approaches represent the most effective means of extending the intended efficiency, rationality and flexibility of a ratings-based approach to a wider range of securitization transactions and activities, and would advance the same underlying policy goals.

II. DEFINITIONS

The Association generally agrees with and supports the proposed definitions of "recourse" and "direct credit substitute."8 We agree that establishing consistency in the regulatory treatment of these types of positions will contribute to the Agencies' goal of correcting present inconsistencies in risk-based capital standards applicable to recourse arrangements, on one hand, and direct credit substitutes, on the other. The Association further agrees that whatever the form taken by a securitization transaction or position, the same amount of capital should be required for arrangements that expose a banking organization to an equivalent risk of loss.

We would nevertheless recommend revisions to the definitions of certain types of activities that would be deemed to be recourse or direct credit substitutes. For example, the proposals would treat as recourse or direct credit substitutes any representations or warranties made in connection with asset securitization transactions that are deemed not to be "standard." "Standard representations and warranties" would be defined as those that refer to an existing state of facts that the seller or servicer can either control or verify with reasonable due diligence at the time the assets are sold or the servicing rights are transferred.

The Association believes that this proposed definition is inappropriately narrow, in light of the purpose and customary usage of representations and warranties in asset securitization transactions. In current practice, representations and warranties address a wider range of conditions, events and contingencies than would be considered "standard" under the Agencies' proposed formulation. Such representations and warranties serve to allocate risk between sellers and buyers of assets for conditions, events or contingencies that, based upon the knowledge of the party making the representation or warranty, are not generally expected to arise.

Although such conditions or events are not within the direct ability of any party to control or verify absolutely, representations and warranties as to such matters are customary assurances that are required in the secondary market. They serve to reduce the need for both parties to expend undue efforts and duplicative resources investigating the existence or likelihood of those conditions or events. The fact that the existence or occurrence of the condition or event cannot be controlled or verified absolutely does not increase the likelihood that it will occur, such that additional risk-based capital would in all cases be justified.

The "nonstandard" example cited in the proposals of a representation stating that a pool of mortgages is free of all environmental hazards is a case in point. In many cases, the transaction simply will not proceed if remote event risk concerning the existence of environmental hazards cannot be allocated in this manner. Treating such a representation as "nonstandard" effectively penalizes the maker thereof, in the form of additional capital requirements, for a potential credit exposure that may be no more (and perhaps less) likely to occur than other exposures that may arise with respect to conditions, events or occurrences for which "standard" representations or warranties are made. As a consequence, the underlying assets would be rendered less liquid, increasing the likelihood that they (and their attendant credit risks) will remain on a bank's balance sheet, rather than being securitized.

For the above reasons, the Association believes that a better, more workable and equitable standard would be to treat as a "standard" representation or warranty any assertion that refers to the occurrence of an event or existence of a condition that (a) is made on the basis of a particular knowledge possessed or after having performed reasonable due diligence, and (b) is not expected to result in the imposition of a material cost or expense to the maker thereof, in relation to the value or purchase price of the position as to which the representation or warranty is made.

III. THE MULTI-LEVEL RATINGS-BASED APPROACH

A. Summary of the Agencies' Proposals

The Agencies note that their current risk-based capital standards do not vary the rate of capital assessment with differences in credit risk represented by different credit enhancement or loss positions. To address this shortcoming, the Agencies propose a multi-level, ratings-based approach that would use credit ratings from nationally recognized, statistical rating organizations ("NRSROs") to measure relative exposure to credit risk, and associated capital requirements, for recourse obligations, direct credit substitutes and senior securities in asset securitization transactions.

Under this approach, capital requirements for a recourse obligation, direct credit substitute or senior security would be determined as follows:

* A position in the highest investment-grade rating category would receive a 20% risk weight.

* A position rated investment-grade but not in the highest rating category (i.e., rated from AA/aa to BBB/bbb) would receive one of two alternative treatments being considered by the Agencies: (1) a "face value" alternative, which would apply a 100% risk weight to the book value or face amount of the position; or (2) a "modified gross up" alternative, which would apply a 50% risk weight to the amount of the position plus all more senior positions.

* Recourse obligations and direct credit substitutes that do not qualify under the above criteria and positions rated below investment-grade would receive "gross-up" treatment; that is, the institution holding the position would be required to hold capital against the amount of the position plus all more senior positions, subject to the low-level recourse rule.9

Special rules would apply in the event a recourse obligation or direct credit substitute is deemed to be a "non-traded position." As proposed, such a position would be eligible for the multi-level, ratings-based approach outlined above only if (1) it possesses investment-grade ratings from at least two different NRSROs; (2) the ratings are publicly available; (3) the ratings are based on the same criteria used to rate securities sold to the public; and (4) at least one position in the securitization transaction is traded. For purposes of the proposal, a position is considered "traded" if, at the time it is rated, there is a reasonable expectation that in the near future the position may be sold to investors relying on the rating, or a third party may enter into a transaction such as a loan or repurchase agreement involving the position in which the third party relies on the rating of the position.

In addition, the Agencies have proposed two alternative approaches to the ratings-based approach for non-traded securitization positions: a "ratings benchmark" approach, and two variations of an "internal information" approach. The Agencies note that they may decide to adopt either or both of these approaches, or portions of them, to replace or supplement the multi-level, ratings-based approach for non-traded positions.

B. General Comments

The Association generally endorses and supports the adoption by the Agencies of the proposed multi-level, ratings-based approach, with certain modifications and refinements suggested herein. We believe that such an approach would provide banking organizations with a more efficient and rational regulatory capital framework than presently exists, and afford them greater flexibility in managing their credit exposures through various securitization investment strategies and credit enhancement activities.

The asset-backed securities market is overwhelmingly a rated market. Credit ratings supplied by NRSROs are widely used and relied upon by market participants as reliable indicia of the expected credit performance of a wide range of asset-backed securities, which are supported by an even wider range of underlying collateral types. For these reasons, a system of capital regulation that is based primarily upon ratings supplied by the NRSROs has both logical and practical appeal. In particular, we agree with the Agencies' observation that the use of credit ratings represent an effective means of using market determinations of credit quality to identify different loss positions for capital purposes in asset securitization structures.

However, the Association does not believe that ratings are or should represent the sole source of credit-related information that may be relied upon to determine appropriate levels of capital reserves in connection with asset securitization activities. For this reason, and as discussed below, the Association recommends that the Agencies simultaneously move forward with introduction of various internal information, bank model approaches as a supplement, and potential replacement, for the ratings-based approach. Such internal information approaches would provide individual institutions with the option of demonstrating to their primary regulator that specific assets can be adequately supported with less capital than would otherwise be required, without involving an outside rating agency.

C. Summary of Association Recommendations

In summary, the Association recommends that the Agencies adopt the following methodologies for assessing capital requirements for recourse obligations, direct credit substitutes and other asset securitization positions:

* For traded securitization positions that possess a credit rating in the highest investment-grade category, the Agencies should adopt a 20% risk weighting, as proposed in the Release.

* For traded securitization positions that are rated investment-grade but below the highest rating category, the Association recommends that the Agencies generally adopt the "face value" approach for determining associated capital requirements, rather than the "modified gross up" alternative proposed for consideration.

* Simultaneously with the adoption of the multi-level, ratings-based approach, the Association recommends that the Agencies pursue, and facilitate banking organizations' use of, both the historical loss and bank model variations of the internal information approaches outlined in the proposals. Although these internal information approaches were proposed exclusively as alternatives for establishing appropriate capital requirements for non-traded securitization positions, the Association believes they should be available, in appropriate circumstances, for all types of securitization positions, whether traded or non-traded, or whether they are rated investment-grade, non-investment-grade, or unrated.

* In all other circumstances (i.e., where an internal information approach is not employed by the banking organization to determine capital requirements, or in the case of non-traded investment-grade, below investment-grade or unrated positions), the Association believes that "gross-up" treatment would be appropriate.

Each of the above recommended approaches for determining capital requirements for recourse obligations, direct credit substitutes and other securitization positions would continue to be, as they are now, subject to the Agencies' low-level recourse rules. These recommendations are discussed in detail below.

IV. DISCUSSION

A. Risk Weighting of Positions Carrying the Highest Investment-Grade Rating

The Association strongly supports the adoption of a 20% risk weighting for all traded securitization positions that possess a credit rating in the highest investment-grade category from one or more NRSROs. As discussed below, we believe that the historical credit performance of investment-grade asset-backed securities positions amply justifies a significant reduction in capital risk weights for triple-A rated positions. Securities possessing the top investment-grade rating represent the highest order of credit quality within this larger universe of asset-backed securities positions. As such, their credit profile and historical default performance are appropriately equated, for capital assessment purposes, with other assets and securities that presently enjoy a 20% risk weight.10

B. Risk Weighting for Other Investment-Grade Positions

A similar analysis may be applied to other traded investment-grade securitization positions that do not qualify for the highest investment-grade rating. As noted above, such positions have exhibited an extremely strong credit performance history. These positions are supported by underlying assets that are generally of very high credit quality, and are also structured with internal and/or external credit enhancements that provide significant protection from default risk.

There has never been a default in the publicly-offered non-mortgage asset-backed securities market. In addition, Moody's Investors Service, Inc. ("Moody's) has never had occasion to assess a performance-related downgrade to any of the approximately 3,200 non-mortgage asset-backed securities rated by the agency as investment-grade. The credit performance of the investment-grade mortgage-backed securities sector is comparable. The likelihood of default for such securities is exceptionally low. For example, a recent study indicates that of 8,685 residential mortgage pass-through tranches rated by Moody's between 1987 and 1985, only 0.2% were rated at the Caa level, which typically indicates that the security is in default.11

The credit performance of investment-grade asset-backed securities thus compares quite favorably with (and arguably exceeds that of) other types of unsecuritized assets that comprise bank portfolios. This exceptionally high credit performance has contributed to significant credit risk reduction within individual institutions, and throughout the banking system as a whole. On this basis, investment-grade asset-backed securities positions should not be subjected to less favorable risk-based capital treatment than other unsecuritized, non-investment-grade bank assets. In particular, the Association believes that the "face value" alternative proposed by the Agencies represents a far more appropriate capital treatment for such positions than the alternative "modified gross-up version" under consideration.

As a rationale for advancing the modified gross-up treatment, the Agencies cite concern that some junior positions-so-called "thin strip" mezzanine positions-in asset securitizations may receive an investment-grade rating, despite a concentration of risk that potentially exposes such positions to losses of greater severity in comparison with a similarly rated, larger position, if a default in fact occurs. This concern apparently arises from the observation that some rating agencies do not take into account the severity of loss posed by this risk concentration when rating thin strip mezzanine positions, and that other rating agencies may do so in a way that is insufficient for risk-based capital purposes. The Agencies cite, but do not describe in any detail, "some evidence" that investors account for the additional concentration of credit risk in thin strip mezzanine positions by demanding higher yields for these positions, especially where ratings do not account for the severity of loss.

The Association does not believe that the Agencies' concerns over the adequacy of ratings of thin strip mezzanine positions are sufficient to justify the imposition of what would, in most situations, amount to substantially greater capital requirements for investment-grade positions in comparison to the face value approach. If adopted, the modified gross-up treatment would apply to all investment-grade positions (except positions having the highest investment-grade rating) within a securitization structure, and not solely to "thin strip" mezzanine positions, however defined. Thus, the structural feature that prompted the Agencies' consideration of the modified gross-up option would not be present in all, or indeed many, securitization transactions.

At a more basic level, imposing the modified gross-up treatment and its corresponding increased capital requirements conflicts with the Agencies' stated desire to establish capital levels that more closely reflect a banking organization's relative exposure to credit risk. Both a "thin strip" mezzanine position and a similarly rated "whole" asset-backed securitization position carry the same investment-grade rating. Such positions accordingly should present the same absolute risk of default. Given the historical credit performance of investment-grade positions-particularly the fact that to date, no investment-grade asset-backed security has experienced a default-the potential for losses of greater severity in the event of default of a "thin strip" position, as compared with the default of a similarly rated "whole" security, is at most a theoretical concern that has not been adequately established by any available evidence. Such a concern should not be the basis for imposing capital requirements that could have materially adverse economic consequences for bank securitization activities.

C. Treatment of "Non-Traded" Positions

As described above, the Agencies have proposed special requirements that "non-traded" investment-grade asset securitization positions would need to satisfy in order to be eligible for the multi-level, ratings-based approach. The Agencies suggest that these requirements would respond to concerns expressed by a rating agency that the holder of a recourse obligation or direct credit substitute that is not traded or sold may, in some cases, request a rating solely to qualify for a favorable risk weight. Without the counterbalancing interest of investors who will be relying on the rating, the Agencies cite the further concern that rating agencies may have an incentive to issue inflated ratings.

The Association generally agrees that variation in the quality and meaning of credit ratings supplied by NRSROs represents a potential threat to the integrity of a risk-based capital framework that relies substantially on such ratings for purposes of establishing appropriate capital levels. As such, we believe that the special requirements proposed by the Agencies to guard against this potential threat in the case of "non-traded" positions are a reasonable response. As more experience is accumulated with the ratings-based approach, however, the Association recommends that the Agencies reassess whether adequate incentives exist for rating organizations provide accurate, "uninflated" ratings for both "traded" and "non-traded" positions.

Rating organizations derive their economic viability from continued investor confidence in the quality and reliability of ratings they assign. They undertake significant efforts to disseminate ratings, and the analysis underlying those ratings, to the investor community and general public through a variety of communications channels. The professional credibility and reputation of rating organizations are placed at issue with every rating they assign, since their long-term franchise depends on the integrity of their credit rating judgments over time. Strong business incentives therefore exist for rating organizations to assign accurate and reliable credit ratings to all rated positions, whether or not they are expected to be traded. As a general matter, we believe that these long-term incentives outweigh any short-term financial incentive a rating organization may have to issue an "inflated" rating for a position that it may not expect (but has no way of knowing) will be sold or traded in the market.

In any case, the Association believes that the Agencies are equipped to monitor and react, as necessary, to any variations that may be observed in the quality or meaning of ratings assigned by different NRSROs to traded positions. Significant differences in yield spreads observed among similarly structured securities or positions rated by different rating organizations would provide a clear signal, both to regulators and the financial markets alike, that those ratings may be biased (thus introducing potential distortions to a regulatory approach that relies principally on those ratings for assessing risk-based capital charges). A prompt regulatory response would be appropriate at that time.

D. Internal Information and Bank Model Approaches

As outlined above, the Association recommends that the Agencies pursue, simultaneously with the adoption of the multi-level, ratings-based approach, both the "historical loss" and "bank model" variations of the internal information approaches described in the Release. Although these internal information approaches were proposed exclusively as alternatives for establishing appropriate capital requirements for non-traded securitization positions, the Association believes they should be made available, in appropriate circumstances, for all types of securitization positions-whether traded or non-traded, or rated investment-grade, non-investment-grade or unrated. Due primarily to its complexity and likely administrative impracticality, the Association does not believe that it would be worthwhile for the Agencies to pursue the "ratings benchmark" approach that was also outlined in the Release.

The Association believes that the overall goal of risk-based capital regulatory initiatives should be to achieve the most efficient possible allocation of capital throughout the banking system. Achieving this goal essentially involves striking an appropriate balance between legitimate regulatory goals and financial market needs. The Association supports a regulatory mandate to assure that an adequate capital cushion exists at all times to preserve the safety and soundness of the banking system, and its constituent institutions, in the event of unforeseen and/or catastrophic credit losses. On the other hand, the Association believes strongly that regulatory risk-based capital reserves are properly required only to the degree that they are demonstrably necessary to guard against actual credit risks. Capital reserves that are required above this level are inefficient, since they reduce the available supply and increase the cost of capital that could be devoted to other productive applications.

The Association believes that over time, individual banking organizations and the larger banking system will naturally gravitate toward the most efficient solution. Competitive economic forces will continue to allocate capital and investment to their most productive uses, and establish appropriate incentives for individual institutions to achieve the highest possible risk-adjusted returns. Specifically with respect to allocating capital against credit risk, we believe that the internal information, individual bank model approaches proposed by the Agencies represent the most desirable framework under which this process can evolve. Under these approaches, risk-based capital requirements would be based upon internal credit risk assessments made by banks holding various positions in asset securitization (and other) transactions, subject to regulatory oversight and approval. These approaches would also be consistent with similar approaches that financial market regulators have adopted to address market risk.12

We agree with the Agencies that a number of significant, specific benefits could be derived from applying these approaches to determine risk-based capital requirements for recourse obligations and direct credit substitutes, which would not be available under the ratings-based approach. These include the possibility that a bank's internal risk assessment, if acceptable to supervisors, could effectively substitute for a credit rating, thus reducing the costs and delays associated with obtaining such ratings. Alternatively, an acceptable internal model for measuring credit risk could form the basis for assessing capital requirements on a portfolio, rather than an asset-by-asset basis, thus better reflecting a banking organization's diversification, hedging and other risk management activities.13

The use of internal information and bank model approaches would also enable the Agencies to overcome some of the inherent deficiencies and limitations in a ratings-based approach. Most significantly, these include (1) placing appropriate reliance on the regulated institution, rather than an unrelated outside agency, for making informed judgments about credit risk and corresponding regulatory capital requirements; (2) elimination of the cost, administrative burdens and delays that may be associated with obtaining ratings (especially for recourse and direct credit substitute positions for which ratings are not typically sought or obtained at present); and (3) the capacity that internal models provide to establish finer gradations in regulatory capital requirements, and associated risk weights, for various positions along the credit risk continuum.

The Association endorses the notion that relatively high hurdles should be established in order for any institution to take advantage of an internal, model-based approach for determining required levels of risk-based capital reserves. Such an approach should only be available to those institutions that can demonstrate an effective and continuing capacity to apply sophisticated, comprehensive internal risk management techniques to measure credit risk, and to establish appropriate capital reserves that adequately account for institution-specific risks. Such institutions must be able to demonstrate that they have in place appropriate policies, practices and procedures to quantify and manage the credit risks that are associated with their asset securitization activities.

The Association of course recognizes that additional technical work and practical implementation guidance will be required in order to make internal information approaches widely available to banking organizations for purposes of establishing risk-based capital requirements. However, we believe that these steps can and should move forward quickly. Ultimately, internal information approaches offer the greatest long-term potential for a more efficient and rational risk-based capital system, by removing the regulatory arbitrariness that is inherent in applying uniform capital requirements to all institutions, and overcoming the above-mentioned limitations in the ratings based approach.

At this stage, the Association does not believe that it is necessary or prudent for the Agencies to mandate that banking organizations apply any particular internal information approach or methodology. Instead, the Agencies should be willing to consider a wide range of possible approaches. Banking organizations should be given wide latitude to introduce and demonstrate the validity of various internal information, or individual "value at risk" modeling approaches for assessing credit risks, and allocating appropriate levels of regulatory capital to those risks. As noted above, the Association recommends that these approaches be made available as a supplement, and potential replacement, to the multi-level, ratings-based approach that would otherwise be applicable.

E. Non-Traded Investment-grade, Sub-Investment-Grade and Unrated Positions

In the event that (a) a traded, investment-grade position does not qualify for 20% or face value treatment, as applicable, or (b) a banking organization is not qualified, or is unwilling or unable, to implement one of the internal information approaches outlined above, the Association recommends that the "gross-up" approach generally be adopted.

In these circumstances, the Association recognizes that neither the banking organization nor its regulator will have obtained an independent validation-as reflected in the results of the bank's internal model for assessing credit risk, or a third-party credit rating whose reliability has been subjected to market verification-that the position should qualify for more favorable capital treatment.

IV. CONCLUSION

Again, the Association appreciates the opportunity to comment on these important regulatory proposals. Consistent with the foregoing recommendations, we encourage the Agencies to continue and extend their efforts to improve the regulatory risk-based capital treatment of recourse arrangements and direct credit substitutes in asset securitization transactions.

Should you have any questions, or desire further information or clarification of any of the matters discussed in this letter, please contact the undersigned at 212.440.9403.

Sincerely,

George P. Miller
Vice President,
Deputy General Counsel

cc: Selected Members and Staff of *The Bond Market Association*

1 The Bond Market Association represents securities firms and banks that underwrite, distribute and trade fixed income securities, both domestically and internationally. Our members are actively involved in a wide range of mortgage-backed and other asset-backed securitization activities. More information about the Association can be obtained from our website at *www.bondmarkets.com.*

2 "Risk-Based Capital Standards; Recourse and Direct Credit Substitutes," 62 *Federal Register* 59944 (November 5, 1997), hereinafter referred to as the "Release."

3 The Agencies include the Office of Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

4 As used in this letter, unless defined otherwise, "asset securitization" and "asset-backed securities" are intended to refer to the securitization of both mortgage and non-mortgage receivables and other types of financial assets.

5 For example, total holdings of mortgage-backed securities alone by FDIC-insured commercial banks as of the third quarter of 1997 was $360.2 billion, representing 43% of total securities held. "Total Securities of all Commercial Banks," FDIC Division of Research.

6 59 *Federal Register* 27116 (May 25, 1994).

7 It should be noted that this activity confers broader market benefits, as credit enhancement represents a critical element in the securitization process that allows large blocks of assets to be transferred with relatively low transaction costs.

8 For purposes of the proposals, "recourse" is an arrangement in which a banking organization retains, in form or in substance, any risk of credit loss directly or indirectly associated with a transferred asset that exceeds a pro rata share of the banking organization's claim on the asset. "Direct credit substitute" would be defined as an arrangement in which a banking organization assumes, in form or in substance, any risk of credit loss directly or indirectly associated with a third party asset or other financial claim, that exceeds the banking organization's pro rata share of the asset or claim.

9 The low-level recourse rule, which has already been adopted by the respective agencies of the FFIEC, limits the maximum risk-based capital requirement to a banking organization's maximum contractual obligation.

10 Bank assets in the 20% risk weight category include FHA-insured, VA-guaranteed mortgage loans, Freddie Mac and Fannie Mae mortgage-related securities, and high quality non-agency securities backed by agency mortgage-related securities.

11 "Credit Shifts in Residential Pass-Through Securities: A Rating Transition Study Update," Moody's Investor Services, Inc. (May 3, 1996)

12 The current U.S. risk-based capital standards for the market risk exposure of commercial banks are based on an amendment to the 1988 Basle Capital Accord. Under the so-called "internal models" approach, these capital charges are based on the "value at risk" estimates generated by banks' own internal, risk measurement models using standardizing regulatory parameters for holding periods and percent coverage. See "Regulatory Evaluation of Value-at-Risk Models," Federal Reserve Bank of New York Staff Reports, Number 33 (November, 1997).

13 These motivations appear to be consistent with those underlying other FFIEC initiatives to encourage banking organizations to manage and oversee their risks on a portfolio-wide and institution-wide basis. See, for example, proposed "Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities," 62 *Federal Register* 51862 (October 3, 1997).