

October 22, 2010

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Jennifer J. Johnson Secretary Board of Governors of the Federal Reserve System 20th Street and Constitution Avenue, NW Washington, DC 20551 Docket No. R-1391 RIN 7100-AD53 Mr. Robert E. Feldman Executive Secretary Attention: Comments Federal Deposit Insurance Corporation 550 17th Street, NW Washington, DC 20429 RIN 3064-AD62

Regulation Comments Chief Counsel's Office Office of Thrift Supervision 1700 G Street, NW Washington, DC 20552 Attention: OTS-2010-0027 RIN 1550-AC43

Re: Advance Notice of Proposed Rulemaking Regarding Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies

Ladies and Gentlemen:

Andrew Davidson & Co., Inc. welcomes the opportunity to comment on the Risk-Based Capital Guidelines of the Federal Banking Agencies: Alternatives to the Use of Credit Ratings. We are a fixed-income research, analytics and consulting firm focusing on the MBS, ABS and structured securities areas. We provide prepayment, credit and valuation models, and consulting services to over 150 financial institutions. Approximately one-third of our clients are depository institutions.

Our response consists of a general introductory section, where we discuss the concept of riskbased capital and respond to all of the questions within the ANPR broadly, followed by sections where we respond in more detail to specific questions (#1, #2, and #7) which particularly fit our areas of expertise.

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INTRODUCTION

In a variety of papers and presentations, we have expressed our support for reducing reliance on ratings in risk-based capital (RBC) calculations. Instead, we recommend that RBC be calculated based on analytical measures of risk. These analytical measures of risk should be calculated using multi-scenario, cash-flow methods.

In our response to the ANPR, we describe various methods and measures that we believe are appropriate standards of credit-worthiness, particularly for securitization exposures. Additionally, we explain why ratings are not the appropriate tool for calculating RBC, independent of the quality of the analysis used to produce the rating. First, we describe what RBC is and some desirable properties for credit-worthiness measures used to calculate RBC.

RBC: Definition & Basic Properties

Risk-based capital is usually defined as the amount of capital or excess assets that a business requires so that its balance sheet remains solvent over a specified time horizon with a specified confidence level or solvency frequency. Inherent in the definition is the idea that over the time horizon we specify, we can imagine a wide range of potential economic scenarios evolving, some of them good and others quite challenging for the firm.

This definition implies that our measure of risk-based capital should assess the difference in losses on our portfolio between the "average scenario," commonly measure by expected loss (EL) and some measure of loss in a stressed environment. The stressed environment can be reflective of particular historical events or a quantitative measure that reflects the probability of surviving a wide range of scenarios. For example, we can require that firms be able to survive the 2007-2009 recession, or we could require firms to operate at a 95% confidence level or solvency frequency. This means that we would like the firm to be able to survive (in the sense of positive net worth) 95% of those environments and only fail in 5% of them. There are 3 types of approaches that can be used to measure the stressful loss: (1) A single-scenario stress test (2) Expected loss plus a multiple of standard deviation of returns (EL+no) and (3) Expected Shortfall.

(1) A single-scenario stress test would specify a single path corresponding to the worst-case economic event that we want the firm's portfolio to be able to survive. The advantage of a stress test is its simplicity and the ease of explaining the results. The disadvantage is that relying on a single scenario may be unrealistic, and can lead to concentrations of model risk or portfolio concentrations of "cliff" securities. Additionally, measures of tail risk diversification cannot be effectively computed since the implied assumption is one of perfect correlation across the entire portfolio. Value-At-Risk (VAR) is an example of a single-scenario risk measure.

(2) The EL+no approach uses some multiple of the standard deviation of returns to set the stress level. This approach measures the historical or expected standard deviation of risk, and then applies a multiple of this risk level to determine capital requirements. It is often used for market risks.

(3) The expected shortfall approach is similar to VAR but addresses some of the short-comings of pure VAR (including excessive numerical sensitivity and potential lack of a diversification benefit). The method defines ES(x) as the average of the worst (1-x)% of losses. We can think of the stress test as a special case of ES where we are averaging over a single path.

In each case the risk of the firm in the stress case must be compared with the earnings power of the firm. Firms generally have income levels that compensate for average losses, so it is not unusual to compare the stressed loss to the average or expected losses. For this method to work, it is important to ensure that firms have adequate reserves and income to cover expected losses before analyzing stress scenarios. All three approaches discussed require analytics to be run, with precision increased if the analytics can be run at a security or loan level. However, for computational efficiency analytics could be run at some level of aggregation as well.

While a stress test can be specified either on a probability basis (e.g. 95% of a simulated distribution) or corresponding to specific historical or hypothetical scenarios (deep recession, Great Depression, etc.) a methodology that combines both historical and probability approaches would be ideal, because relying solely on specific historical scenarios or current volatilities could lead to a misallocation of capital. The choice of stresses can also be used to make the measures more or less pro-cyclical.

These three measures are similar to those used to produce ratings. Ratings generally are distance to default measures, where higher ratings reflect the ability of the obligor to survive a stressful environment. The analytical measures described above also incorporate asset-level income and loss severity and can be used to combine exposures from multiple assets, and therefore will produce more sound measures of bank capital requirements.

Finally, different methods and calculations may be appropriate for investment portfolios that have long term funding versus a trading book. Capital requirements for investment portfolios are best measured using cash-flow based methodologies, while the capital requirements for the trading book are best based on market value sensitivities. Trading books will generally have shorter time horizons, but are exposed to added liquidity and basis risks.

Applying These Concepts

In order to apply these concepts broadly across the asset classes discussed within this ANPR (sovereign, public sector entity (PSE), bank, corporate, and securitization), we believe some consistency is required in the principles behind the process used for each asset class. This will

ensure that adding the numbers or combining them using some correlation-based formula is meaningful.

(1) Fundamentals: We believe that for all asset classes, key economic, financial and fundamental data about the entity should be the inputs into the RBC calculation. For example, allowing the use of: ratings for some asset classes, membership in the OECD or IMF lending arrangements for sovereigns, and equity/CDS market-based approaches for corporate and then combining these numbers with capital numbers based on loan-level cash-flow simulation analysis for securitization exposures may lead to a result that has no clearly defined meaning. Deviations from an analytic, quantitative approach, which may be necessary for practical reasons, should nevertheless tie back to the fundamental definition of risk-based capital, the stress level it is meant to sustain, and a consistent time horizon. In particular, we believe that in the past, the rating agencies views of corporate bonds, municipal bonds and non-agency MBS did not meet this consistency principle: they used inconsistent time horizons, had different definitions of what particular ratings meant, and (even apart from the fact assumptions for MBS were wildly inaccurate) as such formed a poor basis for any mapping to risk-based capital.

(2) Empirical Test: These key economic and financial variables should have demonstrated ability to predict observed empirical default and severity rates. While the specific combinations of variables and financial ratios that have good predictive power may vary by asset class, we believe that they will broadly address the same underlying fundamental issues: the maturity structure/liquidity of the obligors debt, the variability and sources of its income, the relationship between its debt service and other liability cash-flow obligations to its income cash-flows across a range of economic scenarios ranging from average to extreme, and potentially its net worth (for sovereigns unique factors such as ability to issue debt in the home currency, lending facilities they have access to, etc. may substitute for net worth considerations).

(3) Stress Level: The level of economic stress and the time frame for analysis that the minimum RBC requirements are based upon, in the sense of the percentile used in our general introduction section, should be very similar across exposure categories. This is because any capital subsidy granted to a particular exposure category, such as PSEs, can result in (a) a misallocation of risk capital to that category and (b) a potential over-concentration of debt investment in that category by the banking sector and a parallel over-leveraging of capital structure by entities within that category. We believe that regulators should set the stress level consistent with a given category of institutional riskiness and regulated entities should be responsible for modeling RBC themselves or licensing a third-party analytics provider to do so.

(4) Importance of Overall Leverage Limit: Despite every attempt to introduce RBC rules that do not permit regulatory arbitrage, the possibility remains that some combination of

structuring, innovation and model error will eventually result in an arbitrage opportunity. This is why it is important to supplement the detailed RBC calculations and minimum RBC limits with an overall leverage limit using tangible forms of equity and asset notional values (non-risk-weighted). Ideally, this limit could also be based on some empirical considerations having to do with the frequency of systemic banking crises across the world as a function of overall leverage limit regimes.

(5) Encourage Granular Computation: In general, the preferred level of computation of riskbased capital is at the single loan or security level. To the extent that bucketing of categories is allowed, the methodology should introduce an inaccuracy penalty that assumes that all assets within a bucket are perfectly correlated, and that each exposure within a bucket behaves like the worst example within that bucket.

SPECIFIC QUESTION RESPONSES

Response to Question 1

We believe that the broad principles presented in the ANPR are appropriate, with the exception of the word "same" in the second principle. We believe that "similar" assessments for similar exposures would be a better goal.

Additionally, we believe that where these broad principles inherently contradict or conflict with each other, additional principles are needed to resolve the conflict. For example, minimizing opportunities for regulatory arbitrage and fostering prudent risk management will necessarily entail some complexity and add some burden to banking organizations.

We believe that the goal of having banking organizations of varying sizes and complexity arrive at similar assessments of similar exposures may best be achieved by allowing large, complex entities to model exposure-level RBC internally, whereas smaller institutions may need to either outsource their computations or be subject to some aggregation/bucketing approaches (exposure category-based approaches). Therefore, an additional principle might be that when particular asset classes are too complex for a banking entity to model or too costly to outsource the analysis for RBC purposes, the firm should face concentration limits in that asset class or be subject to higher capital requirements so as to minimize risk of insolvency.

Response to Question 2

Using Exposure Categories:

The potential advantages of using risk-weights based on exposure category are simplicity, uniformity, ease of examination process, low burden on depositories, and increased transparency. However, the advantages of simplicity and transparency are only realized if the determination of what exposure categories a particular security or group of loans fall into is itself relatively simple. For example, for some commercial loans or corporate bonds, this determination may be easy to make. On the other hand, for complex MBS or ABS (or other structured securities), the categorization process itself may be quite difficult.

The disadvantages of using risk-weights based on exposure category are the potential for RBC arbitrage, the difficulty of categorizing for more complex exposures as noted, and the fact that it is difficult to incorporate an internal diversification benefit easily. Difficulties with categorical approaches, such as the ratings approach currently in use and those mentioned in the ANPR, can be expected for structured securities, as the examples in our response to Question 7 will highlight.

Exposure-Specific Risk Weights:

The advantages of using exposure-specific risk weights are that this approach limits RBC arbitrage, leading to a much better allocation of capital and alignment of RBC with true portfolio risk (both within and across regulated institutions). Additionally, more advanced measures can handle diverse, realistic correlation structures.

The potential disadvantages of exposure-specific risk weights are a more difficult examination process, more work to ensure uniformity across institutions and a greater burden on regulated institutions than the exposure category approach. However, for institutions that have significant exposure to complex instruments, we believe that the benefits of limiting RBC arbitrage and aligning RBC with portfolio risk significantly outweigh these costs.

A hybrid methodology could use analytical methods to map positions into exposure categories. This method would retain some of the transparency advantages of a categorical approach, while gaining the more accurate risk assessment of an analytical exposure-specific approach.

Ensuring Consistency:

RBC consistency across regulated institutions using the exposure-specific approach can be achieved by (1) setting uniform stress levels across classes of regulated institutions, (2) establishing and publishing benchmarks for a wide range of representative securities and loans, and (3) having examiners test underlying assumptions of each RBC analytics process against uniform stress standards. Additionally, independent third parties could be engaged as part of an examination process to check internal assumptions of sophisticated institutions that do not outsource or use published grids.

Banking regulatory agencies already face such consistency issues in interest rate risk management and mortgage banking. For example, the interagency guidance on mortgage banking is designed to ensure consistency and accuracy in the treatment of mortgage servicing (February 25, 2003). It includes guidance on the appropriate use of market-based assumptions that are "reasonable and supportable" in estimating the fair value of servicing assets. The specific guidance to examiners includes content on validating modeling assumptions such as prepayment speeds, discount rates, etc. Similarly, financial regulators have issued inter-agency guidance on sound interest rate risk management ("Advisory on Interest Rate Risk Management", January 6, 2010) which includes sections on governance, measurement and monitoring of interest rate risk, simulation methodologies, stress testing, and key assumptions. We believe that similar approaches should be applied to risk-based capital determination.

Bifurcated Approaches:

To balance the trade-off between institutional and supervisory burden versus the potential for RBC arbitrage, it may be possible to use a bifurcated approach which depends on the complexity of the regulated institution's portfolio. The use of exposure category-based RBC numbers for vanilla exposures (bonds or loans with no optionality, embedded derivatives or cash-flow structuring) while requiring analytical, cash-flow simulation-based approach for complex instruments could be justified, subject to certain caveats. Such an approach would still require adherence to a common stress standard, and the diversification calculation, if any, would be an external input rather than a natural internal parameter. As we have noted in our introductory section, the use of categories should include the assumption that any exposure within a category requires as much capital as the riskiest example within that category, and that all members of a category are highly correlated.

Response to Question 7

Most of the advantages and disadvantages of exposure category-based approaches for securitization exposures are similar to our response to Question 2. However, the contrast between the use of categorical approaches, such as exposure category-based risk weights and exposure-specific analytics, is much greater. This is due to the complexity of securitization structures and inevitable innovation in structures. Specifying RBC by exposure category becomes even more arbitrage-prone than in the general case, even with exposure category approaches that are more granular than a pure ratings-based approach.

As our examples below will show for residential MBS securitizations, the use of ratings or category-based approaches, as well as the use of exposure-specific supervisory formulas, perform quite poorly at differentiating the risk of tranches compared to the multi-scenario cash-flow generation-based ES or stress approaches. For our examples, we use two securitizations: SEMT 2010-H1 and CWABS 2006-8. The first securitization was backed by super-prime jumbo collateral originated towards the end of the financial crisis and can be viewed as an example of a pristine high credit quality MBS securitization. The second was a subprime securitization with very poor collateral quality originated right at the beginning of the housing downturn. All our analysis is as of 8/31/2010, with security balances and performance updated through this date.

	Scen Weig	ario hting			
Scenario			Interest Rate		
Number	Scenario Name	2-Year HPA	Shock (bp)	EL	ES
0	Base Case	+3%	0	65%	-
1	Moderate Stress	-8%	62.5	30%	-
2	Stress	-17%	125	4%	80%
3	Extreme Stress	-20%	150	1%	20%

Table 1 shows the loss scenarios used for our analysis. We used a base case scenario, and three stress scenarios of increasing severity. In its use of "base" and "stress" economic scenarios, the method is similar to Supervisory Capital Assessment Program (SCAP) of 2009. SCAP defined only one stress scenario, however. We use three stress scenarios, which allows for a more refined evaluation of tail risk. We also define stress in terms of both economic (HPA and interest rate shocks) and collateral loss model stresses (not shown, for simplicity). As such they reflect both economic and model risks – each of which were realized in the recent crisis.

In addition to defining the stresses, we assign two weightings to each scenario. EL is the weighting used in the Expected Loss calculation, and incorporates all four scenarios. ES is used in the Expected Shortfall calculation, and only incorporates the two most-stressful scenarios.

To calculate losses in each scenario, we generated security cash-flows and tabulated the resulting losses relative to a holding price of par. One of the strengths of the method is that losses can be calculated relative to any holding price; clearly a bond held at a price of 50 has less risk than if held at par. To generate the cash-flows we used LoanDynamics[™] and Intex, respectively our credit model and a 3rd-party bond waterfall engine. Regulators and banks are not bound to either, however, as there are many possible sources of both collateral performance and bond waterfall.

The scenarios we show above are illustrative. As mentioned in our response to Question 2, we think it is appropriate that regulators define the scenarios themselves.

Figures 1 and 2 show the collateral and security losses in each scenario, as a percent of the outstanding balance. Current credit support levels as a percentage of collateral balance are shown in parentheses next to each tranche label. Some securities exhibit high loss levels in every scenario (CWABS 2006-8 M3, for example). Others do not incur losses even in the Extreme Stress scenario (SEMT 2010-H1 B1). Additionally, some tranches are highly leveraged to collateral losses. For example, SEMT 2010-H1 B2 losses go from 0 to 16 points between the Stress and Extreme Stress scenarios, while collateral losses increase by only 1 point.

Figure 1: SEMT 2010-H1 Loss Profile



Figure 2: CWABS 2008-6 Loss Profile



It is worth noting that the loss profiles of CWABS 2A2, 2A3, and 2A4 differ substantially, despite identical levels of credit support (29.16%). This illustrates the importance of using a

cash-flow based method to assign RBC for RMBS, which can have highly complex cash-flow waterfalls. A method that solely relies on current credit support levels would not differentiate between the credit risks faced by these tranches.

			Base Case			Expected			
Pool	# Loans	Balance (\$MM)	CumLoss (%)	CumDefault (%)	Severity (%)	CumLoss (%)	CumDefault (%)	Severity (%)	
SEMT 2010-H1	218	201.56	0.05	0.39	12.14	0.19	0.83	23.28	
CWABS 2006-8	5694	1015.1	42.89	66.62	64.39	49.16	70.90	69.33	

Table 2: Collateral Comparison

Table 2 shows the collateral balances, cumulative loss, default and average severity forecasts under our base case (median) scenario as well as the expected (mean) values across the distribution. Expected collateral losses are calculated as the weighted average losses across the scenarios, using the EL weightings in Table 1. The cumulative expected loss for the SEMT deal is about 19 bps, while it is almost 50% for the CWABS collateral.

	8 B	/31/10 alance	Credit Support	Base Case	Expected	Expected	
Security	(\$MM)	(%)	Loss (%)	Loss (%)	Shortfall (%)	ES - EL
Collateral	\$	201.56	-	0.05	0.19	1.64	1.45
SEMT 10-H1 A1	\$	186.16	7.64	0.00	0.00	0.00	0.00
SEMT 10-H1 B1	\$	5.92	4.70	0.00	0.00	0.00	0.00
SEMT 10-H1 B2	\$	2.37	3.53	0.00	0.16	3.20	3.04
SEMT 10-H1 B3	\$	4.14	1.47	0.00	0.90	17.93	17.03
SEMT 10-H1 B4	\$	2.96	0.00	3.24	11.81	84.25	72.44

Table 3: Analytical Measures of Credit Risk – SEMT 2010-H1

Table 4: Analytical Measures of Credit Risk – CWABS 2006-8

	8/31/10	Credit				
	Balance	Support	Base Case	Expected	Expected	
Security	(\$MM)	(%)	Loss (%)	Loss (%)	Shortfall (%)	ES - EL
Collateral	\$ 1,015.11	-	42.89	49.16	73.57	24.41
CWABS 06-8 2A2	\$ 68.36	29.12	0.00	0.00	0.00	0.00
CWABS 06-8 2A3	\$ 387.15	29.12	0.00	6.68	42.54	35.86
CWABS 06-8 2A4	\$ 140.06	29.12	0.00	24.42	86.24	61.82
CWABS 06-8 M1	\$ 73.00	21.93	77.91	85.64	100.00	14.36
CWABS 06-8 M2	\$ 63.00	15.72	100.00	100.00	100.00	0.00
CWABS 06-8 M3	\$ 38.00	11.98	100.00	100.00	100.00	0.00

In Tables 3 and 4 we show analytical measures of credit risk, which are calculated from the scenario cash-flows. The columns after the security identifier show the 8/31/2010 balance (in millions of dollars) and the remaining amount of credit support as measured by remaining balances of subordinate tranches. The computed metrics include the base case loss, expected loss and expected shortfall for the collateral and each tranche. The expected shortfall is

calculated the same way as the expected loss, except only the 2 most-stressful scenarios are averaged (see ES weights in Table 1). We also calculate ES – EL, which is the difference between expected shortfall and expected loss. EL is the "average" loss, and thus should be reflected in either a discounted holding price or excess coupon spread over the risk-free rate. "ES – EL" is unexpected loss, against which firms must hold capital.

			Risk-Based Capital			
			ES		ES	
	8/31/10	Credit	Method	Supervisory	Method	Supervisory
	Balance	Support	(% of	Formula (%	(% of	Formula (%
Security	(\$MM)	(%)	tranche)	of tranche)	deal)	of deal)
Collateral	\$ 201.56	-	-	-	1.45	1.04
SEMT 10-H1 A1	\$ 186.16	7.64	0.56	0.56	0.52	0.52
SEMT 10-H1 B1	\$ 5.92	4.70	0.56	0.56	0.02	0.02
SEMT 10-H1 B2	\$ 2.37	3.53	3.04	0.56	0.04	0.01
SEMT 10-H1 B3	\$ 4.14	1.47	17.03	4.29	0.35	0.09
SEMT 10-H1 B4	\$ 2.96	0.00	72.44	81.75	1.06	1.20

			Risk-Based Capital			
			ES		ES	
	8/31/10	Credit	Method	Supervisory	Method	Supervisory
	Balance	Support	(% of	Formula (%	(% of	Formula (%
Security	(\$MM)	(%)	tranche)	of tranche)	deal)	of deal)
Collateral	\$ 1,015.11	-	-	-	24.41	63.00
CWABS 06-8 2A2	\$ 68.36	29.12	0.56	100.00	0.04	6.73
CWABS 06-8 2A3	\$ 387.15	29.12	35.86	100.00	13.67	38.14
CWABS 06-8 2A4	\$ 140.06	29.12	61.82	100.00	8.53	13.80
CWABS 06-8 M1	\$ 73.00	21.93	14.36	100.00	1.03	7.19
CWABS 06-8 M2	\$ 63.00	15.72	0.56	100.00	0.03	6.21
CWABS 06-8 M3	\$ 38.00	11.98	0.56	100.00	0.02	3.74

*Red numbers indicate an assumed tranche-level regulatory minimum RBC charge of 0.56%. Without this minimum, RBC would be 0.

In Tables 5 and 6 we compare the results of applying the Basel II supervisory formula to an expected shortfall-based method. Capital assignments are shown both as a percent of tranche and percent of deal. Both methods charge similar capital to the SEMT securities, although the ES method disperses capital charges slightly further up the capital structure. This is not the case for the CWABS deal, however. High collateral loss forecasts relative to credit support cause the supervisory formula to break down. It charges 100% capital to all tranches, even the 2A2 tranche that shows no risk in the scenario-based method.

Observant readers will note that the ES method assigns minimal capital to CWABS 06-8, tranches M1-3. This may seem strange; as shown in Figure 2, these tranches incur losses in

every scenario. The same observant reader will also recall, however, that we calculated losses relative to a par price. The high levels of expected loss indicate a mispricing; In fact based on the expected loss, M2 and M3 are nearly worthless and should be marked near zero and M1 should be marked down to reflect its expected loss of over 80 points. At this much lower price the investor must hold less capital against further losses. Our RBC calculation reflects the capital requirement assuming the investor adjusts his holding price to reflect expected losses. If the pricing does not reflect the expected losses, then the result of the calculation should just be the expected shortfall (which is 100% for all three tranches).

						RBC		
	8 B	/31/10 alance	Credit Support	NRSRO		Concentration		
Security	(\$MM)	(%)	Rating	Ratings	Ratio	Supervisory	ES Method
Collateral	\$	201.56	-	-		8.00%	1.04%	1.45%
SEMT 10-H1 A1	\$	186.16	7.64	Aaa	1.60%	8.00%	0.56%	0.56%
SEMT 10-H1 B1	\$	5.92	4.70	A2	4.00%	100.00%	0.56%	0.56%
SEMT 10-H1 B2	\$	2.37	3.53	Baa2	8.00%	100.00%	0.56%	3.04%
SEMT 10-H1 B3	\$	4.14	1.47	Ba2	28.00%	100.00%	4.29%	17.03%
SEMT 10-H1 B4	\$	2.96	0.00	NR	100.00%	100.00%	81.75%	72.44%

Tables 7 and 8: Comparison of Four Approaches

					RBC		
Security	8/31/10 Balance (\$MM)	Credit Support (%)	NRSRO Rating	Ratings	Concentration Ratio	Supervisory	ES Method
Collateral	\$ 1,015.11	-	-	-	8.00%	63.00%	24.41%
CWABS 06-8 2A2	\$ 68.36	29.12	A3/A+	4.00%	8.00%	100.00%	0.56%
CWABS 06-8 2A3	\$ 387.15	29.12	Caa3/B-	100.00%	8.00%	100.00%	35.86%
CWABS 06-8 2A4	\$ 140.06	29.12	C/B-	100.00%	8.00%	100.00%	61.82%
CWABS 06-8 M1	\$ 73.00	21.93	C/CCC	100.00%	27.47%	100.00%	14.36%
CWABS 06-8 M2	\$ 63.00	15.72	C/CCC	100.00%	36.48%	100.00%	0.56%
CWABS 06-8 M3	\$ 38.00	11.98	C/CCC	100.00%	50.88%	100.00%	0.56%

In Tables 7 and 8 we add to the comparison of capital assignments the ratings-based and concentration ratio approaches. For the SEMT deal, the ES Method charges less capital than both methods. In particular, the RBC calculated by the Concentration Method is exceedingly high compared to the other methods. This is caused by the fact that it does not adjust for the credit quality of the underlying collateral.

Comparing the RBC charges for the CWABS deal highlights the problems caused by not using a cash-flow based metric of loss. Ratings, which solely evaluate the default probability, fail to distinguish the relative risk of tranches 2A3 – M3. While it is not unlikely that 2A3 will incur a loss, 2A3 has structural supports not reflected in the Credit Support metric that protect it from being completely wiped out. M3, on the other hand, will almost surely incur a 100% principal loss. Whereas the failure to adjust for collateral credit quality caused the Concentration Ratio

method to overstate RBC for the SEMT deal, for the CWABS deal it causes an understatement of RBC.

If regulators desire additional simplification, the ES method could be used to map positions into risk buckets or categories. For example, if regulators established risk weighting buckets of 10%, 50%, 100%, 250% and deduction and then map positions into each bucket, a potential mapping might look like:

Bucket	Risk weighting	ES-EL
1	10%	<1%
2	50%	<5%
3	100%	<10%
4	250%	<25%
5	Deduction	

The actual categorization might contain more buckets and could include additional considerations beyond the numerical measure of risk. For example regulators might want to ensure that securitization structures meet certain standards in legal structure, risk retention and servicing practices to achieve the lowest risk weights. Moreover, different buckets and ranges of risk weights may be appropriate for different asset classes.

CONCLUSION

Due to the advantages we have highlighted in our response to Question 7, it is clear that analytic measures of risk-based capital are superior to the use of ratings or descriptive categories mapped to capital levels. Additionally, we have demonstrated why a multi-scenario, cash-flow based computation approach is desirable relative to other analytical measures.

We therefore recommend the use of a multi-scenario stress methodology where regulators set the desired level of stress and the calculation that best fits the goals, but with banks or third party analytical providers computing the measures. Additionally, regulators need to evaluate the quality of the assumptions and analysis and provide oversight in a manner consistent with that currently used for interest rate risk and mortgage banking. Finally, similar methods to what we have described here may be applicable much more broadly to other asset classes.

Sincerely,

Indren Davie

Andrew Davidson President