October 15, 2009

Ms. Jennifer J. Johnson Secretary Board of Governors of the Federal Reserve System 20th Street & Constitution Ave., NW Washington, DC 20551	Office of the Comptroller of the Currency 250 E Street, SW Mail Stop 2-3 Washington, DC 20219
Mr. Robert E. Feldman Executive Secretary Attention: Comments/Legal ESS Federal Deposit Insurance Corporation 550 17th Street, NW Washington, DC 20429	Regulation Comments Chief Counsel's Office Office of Thrift Supervision 1700 G Street, NW Washington, DC 20552 Attention: OTS-2009-0015

RE: Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Regulatory Capital; Impact of Modifications to Generally Accepted Accounting Principles; Consolidation of Asset-Backed Commercial Paper Programs; and Other Related Issues;
OCC Docket Number OCC-2009-0012; FRB Docket Number R-1368; FDIC RIN 3064-AD48; OTS-2009-0015

Ladies and Gentlemen:

The Risk Management Association (RMA) appreciates this opportunity to respond to the Notice of Proposed Rulemaking (NPR), dated September 15, 2009, regarding regulatory capital treatment of new accounting rules dealing with consolidation of securitization-vehicle assets onto the balance sheets of financial institutions sponsoring the securitization activity. RMA is a member-driven professional association dedicated to helping financial institutions identify and manage the effects of all forms of risk -- including credit risk, operational risk, and market risk -- on their businesses and customers. RMA's Capital Working Group prepared this response; the Group has been providing independent analysis on matters pertaining to capital regulation since its inception in 1999.

The Capital Working Group agrees, in general, with the main thrust of the NPR, that explicit and "implicit" recourse in the management of securitization activities by major banks subject these banks to credit, liquidity, and other risks that must be accounted for within the capital regulations. However, the NPR has very dramatically different effects on securitization activity depending on whether that activity is truly low-risk or truly high-risk. The main conclusion of our analysis of the NPR is that, if enacted, it would result in minimum capital requirements for certain extremely low-risk securitization activities that would be 500% or more higher than under current rules or under Basel II rules. These low-risk activities -- mainly the sponsorship of certain ABCP conduits -- survived and performed well during the recent crisis, and have been a major part of the day-to-day financing of American business and consumer financial activity. The proposed dramatically higher capital requirements for this form of finance, coupled with difficult competitive equity issues, and other practical problems, could herald the demise of what is a basic support mechanism for our macro-economic system. We therefore recommend that

the following steps be taken by U.S. banking regulatory agencies to address the capital implications of the new Generally Accepted Accounting Principles (GAAP).

a. First, we recommend a one-year "study and assessment" period to accurately measure the effects of the proposal, both for the macro economy and for individual institutions. During this time period, the competitive equity issues associated with U.S. versus international treatment of accounting standards, leverage ratios, and exemptions can be decided. During the study and assessment period, current leverage ratio rules and risk-based capital rules would be applied in the U.S., including the Internal Assessment Approach (IAA) for ABCP conduits.

b. Second, the agencies should, rather than delete the ABCP conduit exemption, revise its language to focus on exempting only those securitization vehicles that can be shown to be truly low risk. The newly crafted exemption language could focus on one-off procedures for achieving exemptions -- procedures that would require continuous compliance to maintain exemption status. Further, in order to avoid the possibly disastrous leverage ratio effects on the ABCP market, the language of the paragraph should make specific that the exemption applies both to risk-weighted assets and to total assets for purposes of calculating the leverage ratio.

   In a less desirable solution, from the point of view of appropriately assigning higher capital to higher risk, the agencies could avoid the "yo-yo" effects, discussed in the text, for risk-based capital purposes (but not the deleterious effects of the leverage ratio requirement) by:

   1. allowing early adoption of the BII IAA, and

   2. allowing the IAA to be applied not only to credit enhancements for unconsolidated conduits but also to those assets that are consolidated from sponsored conduits. More specifically, regulators could specify that IAA calculations may continue to be based on the legal structure of the conduit -- i.e., based on the credit-enhancing liquidity facility rather than on the assets of the conduit -- for qualified low-risk ABCP conduits.

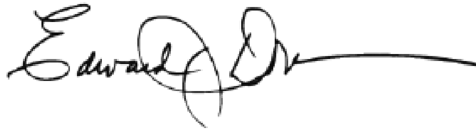
c. Third, with respect to those securitizations that would *not* be exempted from consolidation for capital purposes, the U.S. should implement a phase-in period for the new rules that is <u>at least 3 years in length</u>, to mitigate the macro-economic effects of the new rules. Such a period of time is also in greater concert with the remaining maturities of many securitization positions, thereby assisting U.S. banks in re-structuring securitizations to account for the new GAAP rules.

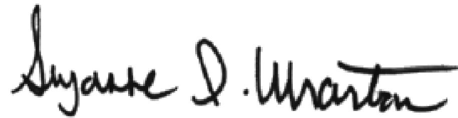
d. Fourth, now is the time for the U.S. agencies to revise the capital treatment of the ALLL and DTA positions of banks, so that loss provisioning can serve a truly counter-cyclical purpose. That is, the ceiling on ALLL inclusion in Tier 2 should be removed, and the ceiling on DTAs flowing from conservative provisioning procedures should be removed. Specifically, incentives should be installed for provisioning to be increased during good periods, and reserves drawn down via the absorption of losses during downturns. Absent regulatory capital action, and coupled with the forthcoming GAAP changes, the

provisioning process will result in less of a cushion against future losses rather than more (because provisions will reduce retained earnings without corresponding increases in what is counted as capital).

Please feel free to contact Ed DeMarco at 215-446-4052 or via email at edemarco@rmahq.org, or Sue Wharton, at 215-446-4089 or via email at swharton@rmahq.org.

Sincerely yours,





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Response to the U.S. Notice of Proposed Rulemaking

Federal Register, September 15, 2009 -- Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Regulatory Capital; Impact of Modifications to Generally Accepted Accounting Principles; Consolidation of Asset-Backed Commercial Paper Programs; and Other Related Issues

Risk Management Association

Capital Working Group

October 15, 2009

1. Introduction.

The Risk Management Association Capital Working Group is pleased to respond to the Notice of Proposed Rule-Making ("NPR"), dated September 15, 2009, dealing with the consolidation of securitization assets on the balance sheets of certain financial institutions and the proposal to delete the current consolidation exemption, for purposes of capital regulation, for certain Asset-Backed Commercial Paper ("ABCP") conduits.

Our Group consists of senior officers working in the area of risk measurement and management at the major banking institutions in the U.S.[1] We continue to support the banking agencies' long held view that capital requirements for the risk positions of banks should be related to the level of such risk, including all risks, not just credit risk. In particular, we believe that capital requirements should be higher for high risk positions, and lower for low risk positions. In the past, Generally Accepted Accounting Principles ("GAAP") in the U.S. and elsewhere, with regard to whether securitization assets should be treated as a true sale (and therefore should not be consolidated), have rested to some extent on the degree to which a bank sponsoring a securitization retained significant risk of the transferred assets. For this reason, it made sense for Regulatory Accounting Principles ("RAP"), as they pertained to capital requirements, to mirror GAAP.

The NPR has been occasioned by very significant changes in GAAP in the form of FAS 166 and FAS 167. Taken together, these new accounting rules for U.S. companies would require the effective consolidation of most existing securitization programs within the balance sheets of the sponsoring institutions. The new rules, to become effective in the first reporting period beginning after November 15, 2009 (i.e., with the first quarter's report of 2010), would cause several trillion dollars of financial assets now residing in bankruptcy remote vehicles (special purpose vehicles or "SPVs") to be added to the balance sheets of banks. Therefore, the main impact of the NPR, if finalized, combined with the new GAAP rules, will be to dramatically increase the *leverage ratio* capital requirements of both the very largest money-center banking companies and the "regional" banking companies that also sponsor securitizations. There will also be very significant changes in the risk-based capital requirements of sponsoring banks. Finally, it is also possible that small community banks will be adversely affected by the new rules, even though their leverage ratio capital requirements and risk-based requirements are not likely to change.

The NPR proposes essentially two things.

a. The banking agencies would not object to the new consolidation requirements of GAAP (in the context of regulatory capital requirements); that is, the agencies would continue to keep RAP consistent with GAAP. Unfortunately, since GAAP now appears to be further departing from standards based on risk, the NPR implicitly ignores the extensive work done by agency and industry personnel over the last two decades in attempting to assign higher capital to higher-risk positions and lower capital to lower-risk positions.

[1] An appendix lists the institutions and staff members that have worked on this response. Not all members participated in this response, and some members may hold views that differ from those put forward in this response.

b. Further, the proposal would rescind existing paragraphs in the capital rules that *exempt* ABCP conduits, but not other kinds of securitizations, from consolidation treatment with respect to risk-based regulatory capital requirements.[2]

The new accounting treatments, coupled with the NPR changes, would have far-reaching and very significant effects on capital markets and, unless carefully managed and phased-in, could dramatically slow the nascent economic recovery.

2. Major effects of the proposals.

A. Capital requirements based on leverage ratio requirements. We are quite sympathetic to the general view expressed in the NPR that complex securitization structures have reduced the ability of investors (those purchasing the liabilities of the SPVs) to fully understand the risk of their positions. This complexity, especially when coupled with the recent crisis, suggests that investors are looking more and more toward explicit and implicit credit enhancements offered by the very largest banks that sponsor much of the securitization activities in the U.S. Indeed, some banks have engaged in what regulators call "implicit recourse" (i.e., voluntary assumption of risk not contemplated by the transaction documents). Such implicit recourse ("IR") has been exercised during the crisis in some forms of securitization that essentially no longer exist -- including SIVs, extendable CP conduits, and SIV-lites or CDO-conduits. Therefore, even though the legal requirements of the transaction documents may provide the sponsoring bank with an option of NOT providing support, it is reasonable to assume that business circumstances may lead to such support being offered.

Moreover, while the major U.S. banking companies have NOT engaged in IR for the vast majority of their sponsored securitizations, it is the case that for internal capital adequacy purposes, many of our Group members measure required capital *as if* the underlying SPV assets had never left the balance sheet of the sponsoring bank. That is, for Pillar 2 purposes dealing with the Internal Capital Adequacy Assessment Process ("ICAAP"), large banks may use, for internal economic capital purposes or for stress test purposes, the assumption that they own the underlying whole loans or senior securitization tranches that are the assets of their sponsored ABCP conduits. Therefore, both because of regulatory concern over IR and because of internal capital-determination processes, the general view that consolidation for GAAP should be mirrored in regulatory capital requirements is understandable.

The major problem with this view, however, is that consolidation, *absent the retention and revision* of the exemption being proposed to be rescinded, results in both a leverage ratio requirement and a risk-based capital requirement being applied to the assets of a SPV sponsored by a major bank. The risk-based capital requirements, with a major exception discussed below, are not the main problem. Rather, the one-size-fits-all leverage ratio requirement of 5%, to achieve "well-capitalized" status in the U.S., presents a classic dilemma that, unless appropriately addressed, could serve to hamstring a time-tested and crisis-tested process for funding low-risk commercial and consumer finance. We are focusing here on the ABCP conduits that are the subject of the paragraph to be rescinded by the NPR. These conduits, by and large, are used to fund extremely low-risk credit assets that, in turn, provide financing for commercial businesses, both large and small, as well as for consumers.

[2] The NPR proposes to eliminate certain language found in the capital regulations for banks, bank holding companies, and thrifts. For BHCs, for example, the language can be found in 12 CFR part 225, appendix A, III.B.6.b, 12 CFR part 225, appendix G, 42(1), and 12 CFR part 225, appendix A, II A.1.c.

Since the crisis, the U.S. ABCP marketplace has contracted from over $1.2 trillion in average outstanding commercial paper to a current level of approximately $600 billion. The NPR, coupled with the GAAP changes, would, for the first time, attach a 5% capital minimum requirement to conduit positions that, since the advent of Prompt Corrective Action in 1991, had been exempt from the leverage ratio requirement *but not the risk-based requirements*. Since 2002, after the introduction of new risk-based capital requirements for these off-balance sheet positions, conduit capital requirements have varied from less than 1% of the underlying SPV assets to well more than 8% of those assets (including risk-based capital of 100% for so-called "first-dollar" securitization positions) -- depending on the actual level of risk associated with the bank's positions.[3] Our concern is that removing the exemption language will cause the capital requirements for the truly low-risk ABCP conduits to rise to such a level that this form of business and consumer financing may literally disappear. That is, at a level of capitalization that is on the order of 3-5 times higher than under current capital rules, spreads on the underlying conduit assets would also have to rise by approximately the same multiple to generate a similar rate of return on required capital. While we are focusing on ABCP conduits, our arguments can be appropriately applied to certain term securitizations, if structured so that the SPV holds low risk assets and the position held by the bank is low risk.

To be clear, our concern is not so much with most term securitizations nor with new forms of ABCP conduits of the sort that received so much press during the crisis. The latter are gone and the former will not be affected so much by the new imposition of a leverage ratio requirement (that is, if a true risk-based capital requirement for the sponsor's positions in a term securitization were, say, 4%, then the imposition of a 5% leverage ratio requirement would raise capital allocation by only 25%, not 300% or 500%). The question, of course, is how can supervisors be assured that an ABCP conduit, or any securitization, is truly low risk from the point of view of the sponsoring banking company? To address this issue, we propose that the exemption language, rather than being rescinded, should be altered -- to require that each ABCP conduit receive an exemption (from consolidation for capital purposes), only if analysis provided by the sponsoring bank meets with supervisory approval that the risk to the bank is truly low.[4] The details of such analysis would need to be worked out, and rules developed for exemption -- however, in the extreme case, we believe that a *one-off* treatment is practical given that there are probably only a hundred or so vehicles that could qualify for the exemption. Qualification for exemption could be on an ongoing basis, to assure supervisors that the asset composition of the conduit, or its legal waterfall construction, had not changed in a way that increased risk to the sponsoring bank to an unacceptable level.

B. Capital requirements under risk-based standards. U.S. banks, since 1991, have been subject to leverage ratio requirements as well as to risk-based standards. Under the current Basel I risk-based standards in the U.S. , most bank assets are subject to a one-size-fits-all 8% total capital minimum requirement. However, securitization positions that do not now require consolidation are treated under the 2002 Basel I rules in the U.S. for risk-based capital -- rules that are specifically designed to reflect the internal rating of the securitization positions. For example, a bank sponsoring an ABCP conduit may have to hold risk-based capital against a program-wide, credit-enhancing, liquidity facility, but not

[3] An appendix traces the history of the current exemption for ABCP conduits, including the arguments for the introduction of the exemption and the evolution of the accompanying risk-based capital requirements.

[4] Note that the current exemption language refers to exclusion "of ABCP conduit assets from risk-weighted assets." In order to avoid leverage ratio requirements for this critical form of finance, the language would need to refer more broadly to both risk-weighted assets and total assets.

against the conduit's own assets (often senior, over-collateralized positions in a "first-level" securitization trust). After consolidation, the securitization assets owned by the conduit could be considered part of the assets of the bank for capital purposes. After this consolidation, under Basel I (2002), the internal rating approach could be applied, but the 10% credit conversion factor for the liquidity facility would no longer be applicable, because the application of the internal rating would be made against various senior securitization positions (and even against junior or residual positions if held as assets of the conduit), not against an undrawn liquidity facility. Since these exposures are to the first-level SPV and are *not* a line of credit or liquidity facility, an *investment grade exposure* would attract a capital charge of 100% * 8% -- at a 100% credit conversion factor not a 10% credit conversion factor associated with the liquidity facility -- so the capital charge would go from 0.80% now under Basel I to a capital charge 10 times higher!

Under Basel II, the risk-based capital charge could be very much lower than the 8% charge in the example above -- but only if, after consolidation, the asset held by the conduit (and which becomes an asset of the bank) is externally rated. That is, under Basel II, the Internal Assessment Approach ("IAA") is thought to apply only <u>to exposures to conduits</u>, not to exposures to the first-level SPV. Such exposures under BII in the U.S. would be subject either to the external ratings-based approach (RBA) or the Supervisory Formula Approach (SFA). So, under Basel II, while it is possible for the risk-based capital charge to approach the current 0.80% level (after consolidation), the sponsoring bank would have to completely realign its processes for computing risk-based capital, seek and pay for external ratings, etc. This would be extremely disruptive to the conduit market and could not easily be solved in the short run. In effect, the bank sponsoring the conduit might see its risk-based capital charge go through a series of changes:

1. 0.80% now for what is a truly low risk position,

2. to, shortly after the consolidation takes place, an 8% capital charge,

3. to, shortly after achieving final approval for BII, an even higher set of capital charges for non-externally-rated positions (including deduction for capital purposes if the SFA or external ratings are not yet in place),

4. to a much lower risk-based capital charge after an "equilibrium" is reached with respect either to the purchase and use of external ratings or the implementation of an SFA.

Clearly one solution to this problem with *risk-based capital requirements* would be to a) allow early adoption of IAA and b) make clear that the IAA could apply both to exposures to conduits and to assets of the conduit that are consolidated (or, more directly, make clear that the sponsoring bank may continue to apply the IAA to the credit enhancing liquidity facility rather than to the assets of the conduit that have been consolidated for GAAP purposes).

Meanwhile, look at the bank sponsoring an SPV that holds low-risk whole loans or trade receivables as assets. Suppose that this bank currently provides a first-dollar credit enhancement of 4% of the SPV's assets. Under Basel I (2002) the capital charge for this bank is a 100% capital allocation against the full notional amount of the credit enhancement, or 4% of the SPV's underlying assets. After consolidation, under Basel I, the sponsoring bank will have to hold the "one-size-fits-all" 8% total capital against the assets of the SPV, no matter how low-risk are those assets. The capital charge to the bank will have

doubled.[5] If the bank -- say, a large regional bank -- is in the process of qualifying for Basel II risk-based capital requirements, this 8% "risk-based" capital requirement would be in effect until the bank completed its parallel-run period and became subject to the risk-based requirements of BII. These BII requirements are built to be risk-sensitive -- being much higher than 8% in the case of high-risk assets (e.g., sub-prime consumer loans) and much lower than 8% in the case of low-risk assets (e.g., over-collateralized short-term credits to middle-market businesses). For this bank, therefore, the risk-based capital requirements would also exhibit a "yo-yo" effect -- rising substantially after consolidation, then falling back down to a reasonable risk-based level -- an effect not to be suffered by European and Asian banks already subject to Basel II risk-based capital requirements.

Thus, whether we are talking about the large bank sponsoring an ABCP conduit, or the regional bank sponsoring a relatively-low-risk term securitization vehicle, the consolidation process will involve very substantial medium term changes, up and down, with regard to *risk-based* capital requirements. And, as noted previously, the effect of the leverage requirement on low-risk securitization activity associated with consolidation may outweigh this substantial risk-based capital effect.

C. Double-counting of the capital requirements and the overall macro effect. In some ABCP conduits, the assets of the conduit may be senior securitization tranches, highly credit-enhanced, of "first-level" SPVs sponsored by, say, a regional bank. For example, the regional bank extends credit to its commercial customers by sponsoring an SPV whose assets are the commercial customers' trade-receivables. That SPV issues securities that are then purchased by the ABCP conduit sponsored by a major bank. These securities are very low-risk because of over-collateralization (of the trade receivables) and also because of any additional credit enhancement provided by the regional bank.

As a result of the NPR and the changes in GAAP, the leverage ratio requirements would apply both to the regional bank and to the major bank sponsoring the ABCP conduit. While the major bank sponsoring the conduit does indeed incur credit risk, such risk is dramatically lower than the risk incurred by the regional bank -- yet, under the proposal, both banks would be assessed the same 5% minimum leverage ratio capital requirement. This double-counting of capital requirements serves to drive up the spreads required by the conduit-sponsoring bank, thereby driving up the cost of funds to the regional bank's SPV and its customers. Thus, the regional bank is hit with a double charge -- a too-high leverage capital requirement in relation to the over-collateralized credit to the middle-market business customer and a higher cost of funds to fund that collateralized credit.

Further, the aggregate additional capital that will be required of banks under the NPR is quite large, something in excess of $100 billion, based on the approximately $4.6 trillion in bank-sponsored SPV assets (excluding GSE-sponsored SPVs).[6] But no one now knows exactly the amount of the needed new capital, and this uncertainty would further disrupt capital markets.

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[5] To properly compare the leverage ratio requirement with the risk-based capital requirement note that the "well-capitalized" risk-based *total* capital requirement is 10% of risk-weighted assets. Moreover, no less than 1/2 of this requirement must be met with Tier 1 capital. Thus, the risk-based well-capitalized total capital requirement is quite equivalent to the Tier 1 leverage ratio minimum requirement for well-capitalized status. Additionally, there is a Tier 1 risk-based requirement for well-capitalized status of 6%. ABCP conduits and other low-risk off-balance-sheet positions, plus low-risk on-balance-sheet positions, may have *risk-weights* under either Basel I or BII of less than 100%, thereby reasonably allowing banks to meet this risk-based Tier 1 well-capitalized standard.

[6] Federal Reserve Z-1 report; $3.94 trillion in non-GSE ABS, plus $600 million in ABCP.

D. Other competitive equity effects of the NPR coupled with the GAAP consolidation. There are other competitive equity injustices that may flow from the combination of the NPR and GAAP consolidation, in addition to the differential effects on regional bank sponsorship of low-risk term securitizations versus large bank sponsorship of ABCP conduits discussed above. That is, both regional and very large U.S. banks may be harmed by possible future differences in the way the U.S. treats the accounting consolidation and the leverage ratio requirement versus that of the rest of the Basel countries. These other Basel countries are currently deciding a) whether to incorporate within the rules of IASB the consolidation requirements now part of U.S. GAAP; b) whether to impose a new leverage ratio requirement at a level similar to the U.S. 5% rule; and c) whether to exempt certain ABCP conduits or other low-risk securitization activities from such a new leverage ratio requirement. Assuming that IASB rules will, within a reasonable period of time, reflect the new GAAP rules, the rest of Basel will face the same issues being described in this response -- namely, how can a one-size-fits-all leverage ratio requirement be made to avoid the pitfalls of such a ratio-based requirement and, therefore, should certain exemptions be put into place. Because of the high potential for the final Basel treatment of these issues to differ substantially from the current U.S. proposed treatment, we recommend that the U.S. delay its implementation of the NPR for a period of approximately one year. During this period, the U.S. and the other Basel countries could study and assess the effects of the proposal on the world's macro economies and on individual large banking institutions. During this "study and assess" period, current leverage ratio requirements and risk-based capital rules for securitization sponsorship would continue to apply in the U.S.

E. GSE new capital requirements further complicate the matter. At the same time the banking industry is being asked to raise $100+ billion in new capital, Freddie and Fannie presumably will also have to raise new capital against the trillions of dollars in their sponsored SPVs that currently reside off their balance sheets. Fannie estimates that it would need to consolidate approximately $2.8 trillion of its own sponsored SPV assets.[7] Presumably, Freddie would need to consolidate a similar level of assets. At current capital requirements for on-balance-sheet assets, this suggests something on the order of another $100 billion in new capital requirements for the GSEs -- in addition to the current "holes" in their existing capital levels relative to current requirements. To the extent these new capital requirements for the GSEs are implemented, rather than ignored under the federal conservatorship,

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[7] Fannie Mae 10-Q (June, 2009). With respect to capital requirements for the GSEs, there is a 2.5% general requirement against on-balance-sheet assets versus a 0.45% requirement against certain off-balance sheet assets. However, the existing capital "holes" for the GSEs, plus any additional capital requirements occasioned by consolidation, are on "hold" under the conservatorship. From the Fannie 10-Q: "On October 9, 2008, FHFA announced that our existing statutory and FHFA-directed regulatory capital requirements will not be binding during the conservatorship, and that FHFA will not issue quarterly capital classifications during the conservatorship. We continue to submit capital reports to FHFA during the conservatorship and FHFA continues to closely monitor our capital levels. We report our minimum capital requirement, core capital and GAAP net worth in our periodic reports on Form 10-Q and Form 10-K, and FHFA has indicated it will report them on its website. FHFA has stated that it does not intend to report our critical capital, risk-based capital or subordinated debt levels during the conservatorship."

community banks' returns on their own sales of mortgages to Fannie/Freddie would have to decline, in order to provide the GSEs with a sufficient return to their new higher capital requirements.

Clearly, no matter how long the federal government exempts the GSEs from the new, additional capital requirements, the impact on capital markets will be severe. Commercial banks would need to have higher spreads on their securitization activities to provide some minimum rate of return on the newly required additional capital; credit spreads in general would rise as banks competed with commercial firms for new equity issuances; as some banks attempted to avoid the consolidation process by divesting themselves of securitization positions, yields on such positions would increase, making it more expensive to fund new credits through securitization. Moreover, a natural response of banks to bringing on the additional assets and incurring the additional capital charges might be to cut back on traditional on-balance-sheet lending to conserve on capital. This is why we believe that, no matter what, the additional capital requirements must be phased-in over a relatively long period of time, certainly no less than 36 months. Such a phase-in process also would be more in line with the effective remaining maturities of many securitization positions.

F. Effect of consolidation on the ALLL and on Deferred Tax Assets ("DTA") versus effective capital levels. The new GAAP treatment will, for certain consolidated assets, require additions to accounting levels of the ALLL (such as when the regional bank's SPV assets are consolidated). This increase in the ALLL does not change the inherent riskiness of the securitization or the level of true risk-based capital that the bank should hold against the underlying assets. But the increased ALLL may further exceed the arbitrary Basel I and Basel II limits on the amount of the ALLL that can be included within Tier 2 capital -- even though this additional ALLL would be truly the first line of defense against losses on the underlying assets. Further, the need to provision would reduce Tier 1 capital (through the income effect on retained earnings), even though the Tier 1 capital requirement might already be made too high by the application of the leverage ratio requirement in the case of low-risk underlying assets.

This treatment of the ALLL runs counter to the desire of regulators and other observers that the ALLL should serve a counter-cyclical role, in which the ALLL can be increased during good times, so as to absorb losses during bad times. This is precisely the role of primary capital items such as retained earnings. Yet, under the proposal, retained earnings would be decreased (as provisions are taken to increase the ALLL), but the additional ALLL (since ALLL levels are already bumping up against maximums permitted to be included in Tier 2 capital) would not be counted as capital. Thus, actual Tier 1 capital would go down after the consolidation, and Tier 2 capital levels would remain unchanged, necessitating an even further raising of new equity.

To see why Tier 1 capital levels would fall note that there are no immediate tax effects of increasing the ALLL, because the recognition of an expense, for tax purposes, only occurs at the time in the future the asset is written down. Thus, the increase in the ALLL will be accompanied by a corresponding increase in DTA, and current regulatory capital rules say that DTA beyond certain levels must be deducted from Tier 1 capital. So, the additional provisioning results in decreases in retained earnings, while the increase in DTA is not counted as Tier 1 capital. Meanwhile, there is no increase in Tier 2 capital. This makes little sense from the perspective of promoting bank soundness. Rather, the "excess reserves" created by the consolidation should count at least as Tier 2 capital and there should be little or no decrease in Tier 1 capital.

Indeed, given the new accounting rules, now is the time for regulators to consider modifying the antiquated treatment of the reserving process for capital purposes. As was the case for accounting

purposes during the 1980s, the ALLL serves exactly the purpose for which retained earnings exist -- to be the first line of defense to absorb losses. That is why reserves used to be accounted for as a positive on the right-hand side of banks' balance sheets, and why regulators defined "primary capital" as including the ALLL. We therefore recommend that, at a minimum, regulators remove the cap on the ALLL for inclusion in Tier 2 capital and at least consider bringing, once again, the ALLL into the definition of Tier 1 capital. Further, the only way to begin using the ALLL as a counter-cyclical measure is to keep the build-up of the ALLL during good times, which necessarily results in a build-up of DTA, from reducing Tier 1 capital as much as it does now. We therefore recommend removal of the DTA limit for purposes of measuring Tier 1 capital. These two measures together would restore the proper incentives for banks to build up the ALLL during boom periods, thus limiting the macro effects of the boom, then use these reserves to absorb losses during bad periods, thus limiting the macro effects of a downturn.

G. The effect of consolidation on the treatment of claims during a bank insolvency. The inability to structure most securitizations as a "true sale" for accounting purposes might result in the loss of the FDIC "safe harbor" now in effect when the FDIC manages a bank in receivership. That is, under current FDIC rules, if a securitization is structured as a true legal sale, investors in an SPV sponsored by a bank have an unimpeachable claim on the assets of the SPV. But investors are faced with "repudiation" risk and "stay" risk if the true-sale treatment of the securitization is uncertain.[8] Depending on how the FDIC treats SPV assets in a receivership under the new GAAP rules, these investors in conduits might be at risk in the case of a bank insolvency. At least one NRSRO (Moody's) has indicated that it may downgrade SPV liabilities as the result of this issue. The American Securitization Forum has petitioned the FDIC to remove the uncertainty associated with this issue in such a way to preserve the positions of ABS holders and to remove the potential for downgrading.[9]

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[8] "Safe Harbor Uncertainty Leads to Uncharted Waters for Card ABS," Moody's Investors Service, September 25, 2009.

"Repudiation exposes ABS investors to two credit risks:
• The FDIC could potentially make a repudiation payment for less than the par amount of the ABS.
• Any repudiation payment (even at par) would likely cause some interest shortfalls to the ABS.
Among its statutory powers, the FDIC, as conservator or receiver of an insured depository institution, has the power to repudiate contracts to which the institution is a party. In general, if the FDIC repudiates a contract, it is required to pay "actual direct compensatory damages" determined as of the date the FDIC became conservator or receiver. A repudiation of a securitization contract would give the FDIC the right to keep the assets backing the securitization so long as it paid damages to the bondholders. The amount of damages would be the lesser of (a) the par amount of the outstanding securities plus interest accrued to the date the FDIC was appointed as receiver or conservator and (b) the market value of the collateral. If the market value of the collateral was less than the par amount of the ABS securities at the time of receivership and the FDIC exercised its repudiation powers, the securities would suffer a loss. Furthermore, even if the market value of the collateral was not below par, if the FDIC exercised its repudiation powers some time after it became appointed as receiver, the repudiation payment would not include interest accrued on the ABS after the date of appointment."

Also, "A statutorily imposed stay following the appointment of the FDIC as receiver would expose ABS investors to the risk of not receiving timely payments of interest and/or principal for up to 90 days following receivership. Following receivership, the FDIC has the power to impose a stay up to 90 days on parties seeking to exercise contractual remedies against the failed institution. This stay could potentially prevent payments on the ABS from being made in a timely manner."

[9] See http://www.americansecuritization.com/uploadedFiles/ASF_Proposal_FDIC_Stmt_of_Policy091809.pdf

In summary, the effects flowing from the NPR, in conjunction with the new GAAP treatment of securitizations, will be profound, affecting financial institutions of all sizes, but primarily those banking companies that are systemically important. Given that these likely effects are so large, so immediate, and yet so uncertain, we recommend that extreme care be taken by the banking agencies with regard to the implementation of their proposals. Our specific recommendations are summarized here:

e. First, we recommend a one-year "study and assessment" period to accurately measure the effects of the proposal, both for the macro economy and for individual institutions. During this time period, the competitive equity issues associated with U.S. versus foreign treatment of GAAP, leverage ratios, and exemptions can be decided. During the study and assessment period, current leverage ratio rules and risk-based capital rules would be applied in the U.S., including the Internal Assessment Approach for ABCP conduits.

f. Second, the agencies should, rather than delete the ABCP conduit exemption, revise its language to focus on exempting only those securitization vehicles that can be shown to be truly low risk. The newly crafted exemption language could focus on one-off procedures for achieving exemptions -- procedures that would require continuous compliance to maintain exemption status. Further, in order to avoid the possibly disastrous leverage ratio effects on the ABCP market, the language of the paragraph should make specific that the exemption applies both to risk-weighted assets and to total assets for purposes of calculating the leverage ratio.

   In a less desirable solution, from the point of view of appropriately assigning higher capital to higher risk, the agencies could avoid the "yo-yo" effects for risk-based capital purposes, but not the deleterious effects of the leverage ratio requirement, by a) allowing early adoption of the BII IAA and b) allowing the IAA to be applied not only to credit enhancements for unconsolidated conduits but also to those assets that are consolidated from sponsored conduits. More specifically, regulators could specify that IAA calculations may continue to be based on the legal structure of the conduit -- i.e., based on the credit-enhancing liquidity facility rather than on the assets of the conduit -- for qualified low-risk ABCP conduits.

g. Third, with respect to those securitizations that would not be exempted from consolidation for capital purposes, the U.S. should implement a phase-in period for the new rules that is <u>at least 3 years in length</u>, to mitigate the macro-economic effects of the new rules. Such a period of time is also in greater concert with the remaining maturities of many securitization positions, thereby assisting U.S. banks in re-structuring securitizations to account for the new GAAP rules.

   During this 3-year phase-in period, we hope that U.S. regulators and regional and money-center banks will try to speed up the movement to Basel II. This risk-based framework is far from perfect, as are its internal counterparts of economic capital, stressed VaR, etc. Such risk-based measures, however, would have been likely to lessen the bubble of the mid-2000's, had they been fully and consistently utilized by bank management to affect business decisions.

h. Fourth, now is the time for the U.S. agencies to revise the capital treatment of the ALLL and DTA positions of banks, so that loss provisioning can serve a truly counter-cyclical purpose. That is, the ceiling on ALLL inclusion in Tier 2 should be removed, and the ceiling on DTAs flowing from conservative provisioning procedures should be removed. Rather, unlike for GAAP purposes or for tax purposes, incentives should be installed for provisioning to be increased during good periods, and reserves drawn down via the absorption of losses during downturns. Absent regulatory capital action, and coupled with the forthcoming GAAP changes, the provisioning process will result in less of a cushion against future losses rather than more (because provisions will reduce retained earnings without corresponding increases in what is counted as capital).

Appendix 1: **Brief history of the "consolidation exemption" for ABCP conduits and the effects of a "one-size-fits-all" leverage ratio standard.**

The Congress, when it enacted Prompt Corrective Action in 1991 legislation, aimed to put a floor on regulatory capital requirements. This floor was in the form of a 5% minimum leverage ratio standard, in order for the bank to be deemed "well-capitalized." Regulators, while generally favoring the floor saw that the resulting capital requirement might be too high for especially low-risk lending. At that time, the fairly new but well-established ABCP market provided an agreed-upon way of exempting low-risk, short-term corporate credits from "too-high" capital requirements (both in the form of the 5% leverage ratio and the newly installed 8% total capital Basel I standard).

Supported by the regulator's tacit agreement that such activities should NOT be consolidated (and therefore subject to the leverage ratio requirement), the ABCP conduit market continued to grow and became a vital engine for supporting economic growth at low risk to banks. During the late 1990's and the first decade of this century, securitizations of all types, not just ABCP conduits, proliferated. Also, some ABCP conduits became devices for funding ever-riskier assets, or were structured in ways that presented certain other risks such as liquidity risk. The increasing complexity of such transactions concerned both regulators and risk management within commercial banking organizations, and made more difficult the process of developing appropriate *risk-based* capital requirements for the securitizations.

The resulting complexities of multiple kinds of securitizations resulted in new risk-based capital rules in the U.S. for such transactions, becoming effective January 2002, and these rules have been largely duplicated within the Basel II risk-based capital requirements now used by all the Basel countries. These new BII rules require:

(a) effectively 100% capital requirements against "residual" or first-dollar positions held by the sponsoring bank.

(b) ratings-based capital requirements against other positions, in which an external rating would be used to determine a regulatory capital charge, or

(c) use of a so-called "supervisory formula approach" (SFA) for unrated positions in which the sponsoring bank must be able to assess the risk of the underlying assets and apply a complex supervisory model to calculate risk-based capital requirements.[10]

Most importantly, the new risk-based capital requirements recognized the unique position of traditional ABCP conduits as low-risk and important in the macro sense, by allowing only these securitizations to use an Internal Assessment Approach (IAA).[11] Under the IAA, the sponsoring bank effectively rates

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[10] As a practical matter, no major bank of which we are aware uses the SFA, because of its operational complexity and expense. Nevertheless, new Basel II rules, not yet codified in the U.S., would require, for Pillar 2 purposes, all holders of securitization positions to "look-through" to the assets underlying such a position, when determining the internal adequacy of capital held against such positions.

[11] Under the 2002 U.S. amendments, the bank can use an "internal rating" approach that is much more crude than the BII treatment, involving distinctions only between and among 3 grades -- investment grade, BB, and

positions that otherwise were not rated, so long as the bank uses a supervisor-approved internal rating process that mirrors the techniques of the major rating agencies. These internal ratings are then used within a regulatory "look-up" table in order to assess specific capital charges against specific ratings levels.[12] Again, the banking agencies saw that ABCP conduits were "special" in that, typically, the true underlying asset positions were short-term in nature and low in credit or market risk, and that the securitization structure itself did not present liquidity or other risks to the sponsoring institution.

The agencies' views about traditional ABCP conduits were publicly reiterated when, during 2003, language was added to the capital rules -- language that clarified that ABCP programs that might be consolidated under GAAP would NOT be consolidated for purposes of risk-based capital requirements. Again, it was clear that the banking agencies did not wish to disrupt the position of the traditional ABCP conduits by having an act of accounting (consolidation) apply a much too high risk-based ratio requirement to the sponsors of these conduits. The new language, however, did not address the application of a too-high leverage ratio requirement to low-risk conduit assets that must be consolidated.

During the second half of this decade, however, several kinds of ABCP conduits emerged that decidedly did not fit the mold of traditional ABCP conduits. These structures included extendable CPs, SIVs, and CDO conduits or "SIV-lites." Meanwhile, term securitizations were being made ever more complex and involved ever more essentially risky underlying financial assets.

Given this recent history of securitization markets in general, it is not surprising that the accounting profession has decided to require consolidation for many securitization transactions. And it is not surprising that U.S. banking agencies should consider following this consolidation process for purposes of determining leverage ratio and risk-based capital requirements. Our view, however, is that whatever might be required for accounting purposes, the agencies are in danger of "throwing the baby out with the bathwater" with regard to capital requirements. In particular, removing the consolidation exemption for ABCP conduits could have far reaching and unintended effects on the financing of U.S. business and the level of macro-economic activity. Moreover, the intent of capital regulation -- to assure minimum conditions of <u>soundness</u> for our nation's banks -- could be compromised by applying too-high capital requirements for certain types of low-risk activity, when the real culprit is that current securitization capital rules may be applying too-low capital requirements for certain other securitization activities.

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below BB. For investment grade positions, the capital charge is based on a 100% risk weight. If an investment grade credit-enhancing liquidity facility is less than a year in maturity, the credit conversion factor is only 10%, resulting in a capital charge equal to 100% * 8% * 0.10 = 0.80%. Under BII, a triple-A rated credit enhancement would be assessed a risk-weight of 7%, but the credit conversion factor for the credit-enhancing liquidity facility would be 100%, resulting in a capital charge of 7% * 8% * 100% = 0.56%. Investment grade positions rated less than AAA would result in BII capital charges well <u>above</u> the Basel I (2002) charge of 0.80%.

[12] We fully recognize the short-comings inherent in a "ratings-based" approach to risk-based capital requirements, especially when NRSRO ratings, in the middle of a crisis, are somewhat suspect. We note that, under the final Basel II rules dealing with securitization positions, no matter the Pillar 1 capital minimum capital requirements, the bank holding a securitization position must "look through" to the underlying assets and to the legal waterfall of the securitization to determine an appropriate level of internal capital adequacy higher than the regulatory minimums.

At the peak of ABCP volume in July 2007, the total ABCP outstanding principal amount was approximately $1.2 trillion. Of that amount, nearly half was represented by newer, non-traditional types of ABCP including: Single-Seller conduits (many of which were extendable issues), SIVs, SIV-Lites (or CDO issuers of ABCP) and Sec-Arb conduits. The remainder was the traditional "Multi-Seller ABCP Conduit." Since July 2007, the ABCP market has contracted to approximately $600 billion (as of June 30, 2009) of which virtually the entire outstanding balance is high quality, traditional Multi-Seller ABCP issued by special purpose corporations administered by major banks. These traditional Multi-Seller conduits represent a significant source of credit to both the consumer and commercial finance sectors. Moreover, the importance of the ABCP marketplace to consumer and commercial finance was recognized early in the crisis by the Federal Reserve Bank of New York, via one of its first emergency lending programs (the Commercial Paper Funding Facility).

In the current political mood, capital requirements based on risk have not been emphasized; rather, the view seems to be "more capital is always better." But this is not literally true. Yes, of course we agree that, for a given set of risk positions, more capital equates to higher "soundness" -- more capital is better. But it is not the case that higher minimum capital ratios are always better:

(a) Higher minimum leverage ratios do not necessarily mean higher soundness, because higher capital ratios can be offset by higher risk assets. During the early 1990's banks with 20% leverage ratios failed within a matter of months in the U.S.

(b) Establishing a minimum leverage ratio has the important unintended effect of convincing investors and other market participants that a bank with a higher leverage ratio is somehow "more sound" than another bank with a lower ratio. This treatment of "the emperor has clothes" has, in the past, worked as a "cover" for some banks to take on exceedingly high risks. Indeed, any bank wanting to exploit the "heads I win, tails you lose" nature of deposit insurance would attempt to have high capital ratios while taking large bets in the form of booking extremely risky assets. Truly risk-based capital requirements avoid this pitfall.

(c) Banks have always had two major devices to avoid unreasonably high capital requirements for specific types of portfolios. First, they could securitize low-risk assets to avoid the too-high minimum leverage ratio requirement.[13] Second, in the Basel I world in which risk-based capital requirements are "one size fits all", they could book additional high risk assets (for which the one-size capital requirement is too low) to offset the too-high capital requirement for the low-risk asset. The combination of the two types of asset -- very low risk and very high risk -- would yield an acceptable rate of

[13] A regulatory capital requirement is "too high" if it is greatly higher than a true, best-practice estimate of the capital needed to maintain a low level of insolvency probability or other definition of soundness. Widely used measures such as Economic Capital, the BII internal risk-based capital charges, and stress tests could be used to assess cases in which the position of the sponsoring bank was truly low risk (e.g., might have appropriate Tier 1 capital of only 2% or less applied, rather than the 5% leverage ratio minimum).

return on the "just right" average capital requirement. Thus, in a world in which securitization is no longer available as a device to avoid unreasonably high capital requirements for low-risk assets, banks would be forced to take on very much riskier activities than they would in the absence of a leverage ratio requirement. This potentially significant and unintended consequence of a "one-size-fits-all" leverage ratio requirement has not recently been mentioned by the banking agencies. [14]

[14] Interestingly, no regulatory releases have said that "a minimum leverage ratio requirement serves to place a floor on soundness" -- because it is understood that such a statement is not unconditionally true.

Appendix 2 -- **Members of the Risk Management Association Capital Working Group**[15]

Bank of America
Capital One
Citigroup
HSBC/North American Holdings
JPMChase
KeyCorp
M&T Bank
PNC
State Street
Union Bank of California
U.S. Bancorp

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Promontory Financial Group: John Costa, Managing Director.

[15] Not all members participated in this response, and some participating members may hold views that differ from those expressed in the response. Also, some members will be responding separately to the NPR.