

June 7, 2000

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: **Risk-Based Capital Standards for Recourse Obligations and Direct Credit
Substitutes (Docket No. R-1055)**

Dear Ms. Johnson:

On behalf of the Federal Reserve Bank of Chicago, I am pleased to have this opportunity to comment on the joint proposal of the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency and Office of Thrift Supervision to amend the risk-based capital standards for recourse obligations, direct credit substitutes and other credit risk exposures arising in connection with structured finance transactions.

The Chicago Reserve Bank supports broad reform of the current standards for regulatory capital to improve the connection between the economic risks banking organizations bear and the capital they are required to hold. In particular, transactions involving equivalent risk exposure should receive equivalent capital treatment, regardless of their formal characteristics and regardless of whether they are undertaken by banks, bank holding companies or thrift institutions. Accordingly, we support the proposed amendments to treat recourse obligations and direct credit substitutes more consistently and to define the term "recourse" and revise the definition of "direct credit substitute."

Moreover, the proposed amendments represent an important step away from the current approach to regulatory capital, in which a banking organization's credit risk exposure is assessed, very inexactly, by identifying the borrower "type" category and applying the fixed weights bank supervisors have formulated for exposures to such borrowers. To assure that capital requirements are closely correlated to the risks banking organizations actually incur, greater reliance must be placed upon actual borrower characteristics. Therefore, we agree that "... a flexible, efficient, market-oriented way to measure credit risk" is needed.

However, we believe that there is a preferred alternative to the proposed "multi-level," external ratings-based approach to assessing the credit risk exposures that banking organizations incur in connection with asset securitizations. As you know, regulatory schemes can change the incentives of the regulated parties and result in arbitrage activities that may undermine the intended objectives of regulation. We believe that, as a long run solution, capital standards based upon internal ratings minimizes such distortions.

Banking organizations that are active in structuring asset-backed securitizations generally have internal risk rating systems that can be used as the basis for regulatory capital requirements. Internal rating systems are routinely used by banking organizations to evaluate borrowers, including borrowers that are not rated by third-parties. Furthermore, banks typically have access to non-public financial information that is specific to the lending relationship. Such information can be used to assess credit risk exposure in a manner that is more accurate and up-to-date than is possible by other means, including third-party ratings. Accordingly, we believe that the adoption of an internal ratings-based approach to assessing the credit risks banking organizations incur in connection with asset securitizations is a more satisfactory basis for regulation.

The Chicago Reserve Bank believes that internal ratings are, in principle, a preferred means of determining the amount of capital a banking organization is required to hold against unexpected losses arising from structured finance activities. Capital is held to protect banking organizations against the loss incurred when a borrower defaults. External ratings are designed only to reflect the borrower's probability of default, not the lender's expected loss-given-default.

In the context of an asset-backed securities offering, an external rating simply expresses the rating agency's opinion of the joint probability that the underlying assets, together with credit enhancements, will be sufficient to permit timely payment of principal and interest to holders of the asset-backed securities. The information a banking organization can derive from a well conceived and implemented internal ratings system is different. Internal ratings systems provide a basis for assessing both the probability of default and the expected loss-given-default to a provider of a credit enhancement. The loss-given-default component of the risk evaluation cannot be inferred from an external rating.

Thus, adoption of an internal ratings-based approach would permit capital decisions to be made upon information both about the probability of default and the magnitude of loss-given-default. For example, Federal Reserve Governor Meyer has observed:

At least in principle, a bank's quantification of probabilities of default, and of loss rates given default, in combination with other information, allows both management and policymakers to determine how much capital is needed to cover unexpected losses within a certain minimum probability. Indeed, I believe that a consensus is developing among G-10 countries around just such a use -- that is to say, a capital accord in which the capital requirements for *individual* banks will

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vary with their *individual* credit risk profiles, based increasingly on the bank's own internal risk evaluations. (Remarks at the Federal Financial Institutions Examination Council, International Banking Conference, Arlington, Virginia, May 31, 2000).

We concur with Governor Meyer's conclusion that a capital framework that does not closely correspond to actual economic risks will simply ". . . create new opportunities for capital arbitrage."

The Chicago Reserve Bank also believes that an internal ratings-based approach makes it unnecessary to formulate specific capital charges for specific forms of credit exposure, such as the early amortization feature of revolving asset securitizations. We recognize that early amortization arrangements, like other forms of credit enhancement, pose credit risks to banking organizations that undertake such obligations. However, a capital regime that imposes a specific charge for particular forms of credit enhancement may invite further regulatory arbitrage of the sort that the proposed amendments are intended to end. One of the merits of an internal ratings-based approach is that it is well suited to permit a comprehensive assessment of a banking organization's credit risk exposure without regard to the legal or other formal characteristics of such exposures.

Banking organizations may also participate in structured financings solely as investors in unsubordinated asset-backed securities. We do not think it is necessary, nor would it likely be useful, to require a banking organization to develop and use an internal risk rating system to evaluate its risk exposure from such investments, unless it is also providing a credit enhancement in connection with the financing. Therefore, the Chicago Reserve Bank believes that external ratings could be a tractable means of determining capital requirements for a banking organization that holds an unsubordinated position (that is, an interest that does not provide credit enhancement to other positions) in an asset-backed securitization.

We appreciate the opportunity to provide comments on the proposed amendments and we hope that they will prove to be useful. If you have any questions concerning our comments, please contact James Moser at (312) 322-5769, Donna Zagorski at (312) 322-5846 or Robert Steigerwald at (312) 322-2414.

Sincerely,

Michael H. Moskow