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Bank Capital Requirements for Retained Interests in Securitizations

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I. INTRODUCTION

Several years ago, Federal Reserve Chairman Alan Greenspan stated that the complex activities of some large banks "may cause capital ratios as calculated under the existing rules to become increasingly misleading." The need for an accurate assessment of the safety of our financial institutions is driving one of the most comprehensive, well coordinated regulatory efforts in banking history. As part of this effort, the Basel Committee, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the Federal Reserve Board (FRB), have issued proposed revisions to capital adequacy guidelines to protect the safety and health of the banking system. The impetus for this extraordinary joint effort to modernize financial legislation is a combination of the globalization of financial institutions and their increased participation in complex financial transactions, most

2. Id.
3. Id. "The Basel Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten Countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. It usually meets at the Bank for International Settlements in Basel, where the permanent Secretariat is located." THE BASEL COMMITTEE ON BANKING SUPERVISION, A NEW CAPITAL ADEQUACY FRAMEWORK, 4 n.1 (Consultative Paper, June 1999). All Basel Committee papers referred to in this document can be obtained from the BIS website at http://www.bis.org/publ/index.htm (last modified Feb. 12, 2001) [hereinafter Basel 1999 Proposal].
notably securitizations.\

While the Basel Committee works on a comprehensive regulatory framework for capital adequacy levels, United States regulators are pursuing several additional regulatory initiatives. In two separate proposals, the agencies are targeting the treatment of recourse, direct credit substitutes, and retained interests created during securitization transactions. Specifically, the agencies are looking at the amount of regulatory capital banks should hold to account for the potential risks of these activities.

The ability to sustain our financial institutions during crises, whether specifically related to one individual institution or a systemic crisis, largely depends on the institutions' ability to absorb unanticipated losses. Many believe when problems occur, adequate capital levels make the difference between a solvent and

4. Blount, supra note 1. "Securitization has also been defined as: the sale of equity or debt instruments, representing ownership interests in, . . . income-producing asset or pool of assets . . . structured to reduce or reallocate certain risks inherent in owning or lending against the underlying assets." TAMAR FRANKEL, SECURITIZATION: STRUCTURED FINANCING, FINANCIAL ASSETS POOL, AND ASSET-BACKED SECURITIES (Supp. 1995), at 5.


6. Proposed Rule for Capital; Leverage and Risk-Based Capital Guidelines; Capital Maintenance: Residual Interests in Asset Securitizations or Other Transfers of Financial Assets; Proposed Rule, 65 Fed. Reg. 57,993 (proposed Sept. 27, 2000) [hereinafter September 2000 Proposal]. Recourse is defined by the agencies as "an arrangement in which a banking organization retains risk of credit loss in connection with an asset transfer, securitization, if the risk of credit loss exceeds a pro-rata share of the banking organization's claim on the assets." Risk-Based Capital Standards; Recourse and Direct Credit Substitutes; 65 Fed. Reg. 12,319, 12,334 (proposed Mar. 8, 2000) [hereinafter March 2000 Proposal]. Direct credit substitutes are defined as: the term "any arrangement in which a banking organization assumes risk of credit-related losses from assets or other claims it has not transferred, if the risk of credit loss exceeds the banking organization's pro-rata share of the assets or other claims." Id. Currently, under the banking agencies' guidelines, this term covers guarantee-type arrangements. Id. As revised, it would also include explicitly items such as purchased subordinated interest, agreements to cover credit losses that arise from purchased loan servicing rights, credit derivatives, and lines of credit that provide credit enhancement. Id. Residual interests are assets that are either un-rated or non-investment grade that are retained by the issuing instrument to provide "first-loss" credit support for senior positions in the securitization. September 2000 Proposal, supra, at 57,997. The banks' interest then is subordinated to all the other investors and they absorb the first credit losses of the transaction. Id.

7. September 2000 Proposal, supra note 6, at 57,997.

8. Id.
insolvent bank. Regulators hope to mitigate bank failures by creating and applying new regulatory capital standards to new activities whose risk might not be fully accounted for by the current capital adequacy standards.

This Note addresses the effect of securitization activities, bank capital levels, and the regulatory response to those activities. In Part II, this Note discusses how banks securitize assets, the types of assets that are being securitized, and the increased reliance by the banking industry on securitizations. It explores, in Part III, the concerns of regulatory agencies regarding securitization activities of financial institutions, recent bank failures, and the impact of increased securitization on regulatory capital levels. In Part IV, the Note examines the regulatory responses of the OCC, FDIC, FRB, and the OTS. Part V analyzes the reactions of the banking community to these provisions while evaluating their effectiveness, as well as their potential consequences.

9. Id. Currently, minimum regulatory capital levels for most banks is 8%. Id. Alternatively, there are those who do not believe that the capital ratio, or “solvency ratio” will protect financial institutions from financial ruin. GIORGIO SZEGO, A Critique of the Basel Regulations, or How to Enhance (IM) Moral Hazards, RISK MANAGEMENT AND REGULATION IN BANKING, 147, 147-158 (Dan Galai, David Ruthenberg, Marshall Sarnat & Ben Z. Schreiber eds., 1999). Factors to support the premise include: the Swedish banks on the eve of bankruptcy in 1992 had average ratios of 9.3%; The Bank of Naples in 1993, just before its troubles had a ratio of 9.98%. Id. The lesson may well be that adequate capital ratios alone will not prevent a banking crisis. Id.


11. See infra notes 15 – 36 and accompanying text.
12. See infra notes 37 – 97 and accompanying text.
13. See infra notes 98 – 139 and accompanying text.
14. See infra notes 140 – 198 and accompanying text.
II. BACKGROUND

Banks borrow money from their depositors and lend that money to others in the community. Banks pay little or low interest on "core deposit accounts." Many banks are now finding this once reliable source of funds in decline as many American investors shift savings from bank deposits into mutual funds and money market accounts. These changes are forcing banks to seek other sources to fund their operations.

Securitization provides both an alternative method of funding for banking institutions and a vehicle to reduce interest rate risk. Through securitization activities, banks are able to sell loans, receive cash to make new loans, and collect origination fees. Once the exclusive domain of large financial institutions, a

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15. MARTIN MAYER, THE BANKERS: THE NEXT GENERATION 2 (First Truman Talley Books/Plume Printing 2d ed. 1998). The difference between the cost of the funds and the interest charged on the loan are what constitute interest income to the banks. Id. at 27. This income used to be the main source of income for banks. Id. Interestingly, many see the future of banking resting in fee earning business, not "net interest income" revenues from lending. Id. The CEO of North Carolina's First Wachovia, Bud Baker, stated "As we look to the future, the traditional ways of making money, the loans and deposits - well, that will be a much more difficult way to make money." Id at 28.

16. Id.

17. Matthew D. Pieniazek, Community Banks Must Look For New Funding Alternatives. AM BANKER, July 7, 2000, at 15. In fact, from 1990 to 1999, according to the Federal Deposit Insurance Corp., assets in the banking system increased 41% to $5.7 trillion, while core deposits rose only 26.6%. Id. At the end of 1999, core deposits were just 47% of assets, against 58% at the end of 1989. Id. An even more disturbing trend is the growth in deposits of wholesale CDs of more than $100,000, foreign office deposits, and non deposit sources of funds like advances for Federal Home Loan banks (which are really loans), which rose 47% in the past decade. Id.

18. Id. Pieniazek also notes that this type of pressure can force banks to take more credit risk than may be prudent. Id.

19. Id. "Interest rate risk is the exposure ... to adverse movements in interest rates. It results from differences in the maturity and timing of coupon adjustments of bank assets, liabilities and off-balance-sheet instruments (repricing or maturity-mismatch); ... and from interest rate-related options embedded in bank products (option risk)." Joint Agency Policy Statement on Interest Rate Risk No. 5000, 61 Fed. Reg. 33,169 (June 26, 1996), at 5,421.

20. Pieniazek, supra note 17, at 15. Many community banks have been reluctant to securitize their mortgage loans or commercial loans. Id. Some of this reluctance may come from a fear that the purchasing financial institution may attempt to poach their best accounts and that the smaller bank would risk losing a valuable part of their customer base. Id. Another more practical issue is that many smaller institutions
growing number of regional and community institutions are beginning to use securitizations to access alternative funding sources, manage concentrations, and meet customer loan demand.  

Asset securitization involves transferring on-balance sheet assets that have been combined in a pool, to a third party sometimes known as a Special Purpose Vehicle (SPV). Normally, a bank will take loans from its portfolio and combine them together to sell. The SPV then sells securities with varying levels of risk and return to investors. The security holders receive payments on the securities that mirror payments received on the underlying pool of loans. Virtually any type of payment stream that generates cash can be securitized, and there are increasingly creative vehicles being developed daily. For instance, bank assets that have been securitized include credit card receivables, automobile loans, commercial mortgages, residential first mortgages, commercial loans, home equity loans, and student loans.

As deposits decline, financial institutions will more likely
participate in the securitization market as an efficient mechanism to mine new sources of cash.²⁸ By accessing the capital markets, banks accomplish several important objectives: they increase liquidity, opportunity for lending, and fee income.²⁹ When less sophisticated players enter the market they may not fully appreciate nor allocate capital for the risks associated with this activity.³⁰ Moreover, a bank's best assets may be continually removed from the bank's balance sheet, resulting in a decrease in the quality of the remaining assets.³¹

Securitization activities are especially sensitive to market conditions and, if a bank has relied on securitization to provide liquidity, then considerable risks may exist for that bank during a downturn.³² During downturns, the capital markets may not be able to place securitization issues with investors, thereby creating liquidity problems for the originating institution.³³ Additionally, in the event of volatile market conditions, retained interests created in asset securitizations and maintained as part of the institution's capital may result in a significant devaluation of the retained interests and an overvalued capital position.³⁴

Both the industry and regulators regard securitization as an important tool for banks.³⁵ Regulators, however, are concerned about the increased risk exposure that securitization generates for banks and the financial system.³⁶

²⁸. Pieniazek, supra note 17, at 15. Banks of all sizes are being forced to aggressively seek out alternative sources of deposits and restructure their primary business model. Id.
²⁹. Id. The importance of securitization will continue to grow since liquidity concerns appear to be a major impediment for many banking organizations. Id.
³². Id.
³³. Id. The bank would have already pooled the loans into the securitized asset and may have tentatively targeted new loan prospects or executed loan commitments based on the anticipated cash flow from the securitization. Id. The inability to market the securitization would cancel the anticipated cash flow and the institution would have an operating income shortfall. Id.
³⁴. Interagency Guidance 1999, supra note 5, at 10. See supra note 6 (defining retained interests).
³⁶. Id.
III. REGULATORY CONCERNS

A. Capital Arbitrage

The 1988 Basel Accord succeeded in creating an international standard for capital levels. However, the accord did not anticipate the increase of securitization activities by banks that has led to a distortion of the capital ratios – and thus their relevance. Under the 1988 capital guidelines, banks have a great incentive to securitize diversified high-quality loans into asset pools with predictable loss rates. The remaining on-balance sheet portfolio may have greater risk and be less diversified than the securitized pools, while the reported capital ratios do not indicate the increased risk to the banking institution from the relatively weaker remaining loans. Additionally, the capital ratio becomes distorted because the total risk weighted assets have decreased, while the capital ratio increases and the bank appears to be more

37. Blount, supra note 31, at 70. The international standard of the 1988 Basel Accord applied consistent minimum capital standards and imposed an eight percent capital charge on the value of a bank’s total risk assets, with two tiers of eligible capital. Id.

38. Rob Garver, Arbitrage Risk Warning to Basel Panel, AM. BANKER, May 23, 2000, at 6. See also PATRICIA JACKSON, ET AL., CAPITAL REQUIREMENTS AND BANK BEHAVIOR: THE IMPACT OF THE BALE ACCORD, (Basel Committee on Banking Supervision Working Papers, No. 1, April 1999), available at http://www.bis.org/publ/index.htm (last modified Feb. 12, 2001) [hereinafter BASEL BEHAVIOR IMPACT]. As an example, a bank may decide to originate fewer BBB-rated loans in favor of more BB-rated loans, thereby increasing return on equity. Id. On the surface, the bank’s total risk weighted assets and regulatory capital appears unchanged. Id. In reality, the bank is engaging in riskier transactions with higher probability of defaults and has increased actual risk to the bank. Id. Therefore, traditional measures that previously measured risk and triggered supervisory and regulatory intervention do not always work. Id. Long and short-term debt have separate rating scales, reflecting different risks assigned by a rating agency such as a nationally recognized statistical rating organization (NRSRO) like Standard & Poor’s, Moody’s, or Fitch IBCA Investors Service. Schwarcz, supra note 22, at 4-5. Standard and Poor’s highest rating on long-term debt is AAA, with ratings descending to AA, then A, and then to BBB and below. Id. Short-term debt is rated A-1, A-3 and below. Id. Any securities rated below BBB- are non-investment grade securities. Id. at 5.

39. BASEL BEHAVIOR IMPACT, supra note 38. The 1988 rule encourages banks to identify and hold assets with low regulatory capital charges relative to the risks they pose to improve the overall quality of assets that banks hold. Id.

40. Id.
financially sound.\textsuperscript{41}

Consistent with the Basel Accord, United States banks are required to meet two minimum capital ratios: a capital ratio and a risk adjusted capital ratio.\textsuperscript{42} The capital ratio has a target range of

\begin{align*}
&41. \textit{Id.} \text{ Below is a representation of a securitization without any retained risks that shows how a bank is able to arbitrage its risk-based capital from 11\% to 13.8\% and total risk-based capital from 12\% to 15\%. \textit{Id.} at 45-46. The example assumes proceeds from the sale of ABS securities are used to reduce the bank's outstanding deposit liabilities. \textit{Id.} at 46. This example assumes no change to reserves at either the bank or the SPV, showing the capital arbitrage. \textit{Id.} The Bank sells $40 loans to the SPV, the SPV sells $40 ABSs to investors, then the investors pay the SPV $40 cash, and the SPV pays the bank $40. \textit{Id.}

\begin{tabular}{l c c c}
\textbf{BANK BALANCE SHEET BEFORE SECURITIZATION WITH ON-BALANCE SHEET LOANS} \\
Loans & 200.00 & Deposits & 176.00 \\
Less Reserves & (2.00) & Equity & 22.00 \\
Total Assets & 198.00 & \\
\end{tabular}

\begin{tabular}{l c c c}
\textbf{EXAMPLE AFTER SECURITIZATION} \\
SPV BALANCE SHEET \\
Loans & 40.00 & ABSs & 40.00 \\
\end{tabular}

\begin{tabular}{l c c c}
\textbf{BANK BALANCE SHEET AFTER SECURITIZATION} \\
Loans & 160.00 & Deposits & 136.00 \\
Less Reserves & (2.00) & Equity & 22.00 \\
Total Assets & 158.00 & \\
\end{tabular}

\begin{align*}
\textit{Id.} \text{ at 45-46. For further examples of other securitization structures, see Appendix 1 for the effects of removing assets from the balance sheet on the capital ratios. \textit{Id.} at 45-52.} \\
42. 12 \text{C.F.R.} \textsection 325 app. A (2000), at 184 (Statement of Policy on Risk-Based Capital, 2000). The capital ratio is computed by taking Tier I plus Tier II capital and then dividing by total assets. Tier I capital consists of common stockholders equity capital, non-cumulative perpetual preferred stock, including any related surplus. \textit{Id.} Tier II capital consists of: allowance for loan and lease losses, up to a maximum of 1.25\% of risk-weighted assets, cumulative perpetual preferred stock, perpetual stock,}
between six to eight percent. After the initial capital ratio is determined the regulators calculate a risk adjusted capital ratio. Regulators require that banks maintain a risk adjusted capital ratio in excess of eight percent. Regulatory agencies utilize these capital ratios as essential tools to evaluate the capital adequacy of banks.

Banks can accomplish another form of capital arbitrage through the use of credit enhancements in securitizations. Several types of credit enhancements commonly used are retained interests, partial recourse, and indirect credit enhancements.

Retained interests provide another arbitrage opportunity for banks. Retained interests are a form of credit enhancement that many securitization structures use to support a higher credit rating on other portions of the securitization that are sold to investors. The retained interest is structured to be the first loss

hybrid capital instruments, term subordinated debt and intermediate-term preferred stock, and net unrealized holding gains on equity securities. Id. at 185.


44. 12 C.F.R. § 325 app. A (2000), at 186. This is accomplished by categorizing the various assets into different risk categories, multiplying the assets by the applicable risk weights factors, and then aggregating the total assets into one risk adjusted number. Id. The final step requires the combination of Tier I and Tier II capital divided by risk weighted assets. Id. Any assets deducted from capital when computing the numerator of the risk-based capital ratio will also be excluded from risk-weighted assets when computing the denominator of the ratio. Id. at 187. The asset is taken and then the risk factor is multiplied by the asset and the sum of all the assets are then considered risk adjusted assets. Id. Current risk assessments are as follows: Cash and US government securities have a 0% risk, loans secured by collateral from U.S. Government agencies, sponsored agencies, and guaranteed by multilateral lending institutions or regional development banks have a 20% risk, first mortgage loans have a 50% risk, all other loans have a 100% risk. Id. at 190.

45. Id.

46. Calamoris & Litan, supra note 43.


48. Id.; supra note 6 (defining recourse, direct credit substitute and residual interests).


position to absorb defaults and its valuation can be volatile depending on the payment experience of the pool. As part of The Reigle Community Development and Regulatory Improvement Act, the agencies initiated a low-level recourse treatment. Many banks were being penalized and required to hold excessive capital, at eight percent of the total underlying transactions, although their risk exposure and credit support may have been less than eight percent. The rule was changed in 1995 to set regulatory capital levels at a dollar for dollar charge for the credit risk exposure, up to a maximum of eight percent of the total underlying transaction. Banks holding less than an eight percent risk exposure were allowed to apply the dollar for dollar capital requirement to the transaction, which more accurately reflected the risk profile of the credit enhancement. However, some banks began exploiting the ambiguity of the rule and structured credit enhancements that were in excess of eight percent of the transaction. This type of arbitrage allows banks to increase levels of risk to the institution without corresponding capital being held to mitigate the risk exposure.

Securitization transactions with recourse can also lead to arbitrage under current regulatory rules. The bank can either

51. Id.
52. September 2000 Proposal, supra note 6, at 57,996. See also Section 350 of the Reigle Community Development and Regulatory Improvement Act, codified at 12 U.S.C. § 4808.
53. September 2000 Proposal, supra note 6, at 57,996.
54. Id.
55. Id.
56. Id.
57. Id.
58. March 2000 Proposal, supra note 6, at 12,322-23. As professionals globally seek to continue harmonization of standards across industry lines, the Financial Accounting Standard Board released a new FASB statement on Securitization, FASB 140, on September 28, 2000. Press Release, The Financial Accounting Standards Board, FASB Issues Statement on Securitizations (Sept. 28,2000) (on file with N.C. BANKING INST.), at http://www.rutgers.edu/Accounting/raw/fasb/news/nr92800.html (last visited Feb. 27, 2001) [hereinafter FASB Press Release Sept. 2000]. In releasing the announcement to the public, Senior Project manger Halsey Bullen stated, “It also became clear that better disclosures were needed about securitizations and something different was needed for collateral, and that a new statement was needed to deal with those matters.” Id. Additionally, FASB 140 seeks to establish consistent standards to distinguish the transfer of financial assets that are sales from transfers that are secured borrowings. Id.
report a securitization with recourse as a financing with recourse or as a "true sale."59 The choice will determine if a bank must hold regulatory capital against these essentially similar transactions.60 A financing will require the bank to hold regulatory capital against the transaction while a "true sale" will not require any capital allocation.61 Under the current rules, a securitization with essentially the same "risk" could be structured so that the bank would not have to allocate capital to the securitized assets.62

Direct credit substitutes are treated differently from recourse obligations under the current risk-based capital standards.63 Generally, an off-balance sheet direct credit substitute, such as a standby letter of credit provided for a third-party's assets, carries a risk weight conversion factor of 100 percent.64 However, capital is only held against the face amount of the direct credit substitute.65

Regulators have become increasingly concerned about the risks securitization activities pose to the financial system, especially during an economic downturn.66 Despite these concerns, banks continue to take advantage of the inconsistencies in the current regulations and structure securitizations that require the

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59. March 2000 Proposal, supra note 6, at 12,322. The bank can treat a securitization as a "true sale" for accounting and regulatory purposes, even though the bank retains risks of the underlying transaction through credit enhancements provided to the SPV. Id.
60. Id.
61. Id.
62. Id. at 12,323.
63. Id.
64. Id. at 12,319. Additionally, purchased subordinated interests receive the same capital treatment as off-balance sheet direct credit substitutes. Id. at 12,323. However, if the same bank had retained a subordinated interest in connection with the transfer of its own assets and transferred them with recourse, the bank would have to hold capital against the carrying amount of the retained subordinated interest as well as any outstanding senior interests it supports. Id.
65. March 2000 Proposal, supra note 6, at 12,323. For example, a banking organization may provide a first-loss letter of credit to an asset-backed commercial paper conduit that lends directly to commercial customers instead of making the loans to the commercial customer itself. Id. This results in a significantly lower capital requirement than if the loans had originally been carried on the bank's balance sheet and then sold. Id. The banking organization is exposed to the same risk of default, without having to allocate capital for that risk. Id.
66. Blount, supra note 31, at 70.
least amount of regulatory capital.\textsuperscript{67} During an economic downturn those institutions that have been manipulating their capital levels and do not have adequate safety nets may become troubled institutions.\textsuperscript{68} Of greater concern is the issue that the regulatory capital required of a bank may not be the same amount that a prudent bank manager would choose to hold in reserve relative to the riskiness of the bank's activities.\textsuperscript{69} These distortions may leave little for the FDIC to salvage in the event a bank failure occurs.\textsuperscript{70}

\textbf{B. Recent Bank Failures}

The number of bank failures in recent years has been low by historical standards and consistent with expectations.\textsuperscript{71} However, two bank failures have resulted in staggering losses of approximately $900 million.\textsuperscript{72} As a result, significant concerns have been raised among regulators and Congress.\textsuperscript{73} Two of the failures responsible for these losses are the First National Bank of Keystone (Keystone), in West Virginia; and Pacific Thrift and Loan Company (PTL), in California.\textsuperscript{74} Both banks had large concentrations of improperly valued retained interests on their balance sheets.\textsuperscript{75} These miscalculations created the "illusion" that each institution had adequate capital.\textsuperscript{76}

Keystone, with over a billion dollars in assets, is expected to be the tenth-largest dollar loss in FDIC history with estimated

\begin{itemize}
\item \textsuperscript{67} March 2000 Proposal, \textit{supra} note 6, at 12,322-23.
\item \textsuperscript{68} Id.
\item \textsuperscript{70} Blount, \textit{supra} note 31, at 70.
\item \textsuperscript{71} Tanoue Feb. Testimony, \textit{supra} note 50, at 10. While regulators want to minimize the effect of bank failures on general economic activity, they have never striven for zero bank failures. \textit{Id}.
\item \textsuperscript{72} \textit{Id}.
\item \textsuperscript{73} \textit{Id}. at 1. The loss rate from a bank failure is defined as the loss to the Bank Insurance Fund (BIF), as a percentage of the total assets of the failed bank. \textit{Id}. Over the last twenty years, the average loss rate has been twelve percent. \textit{Id}.
\item \textsuperscript{74} Chairman Donna Tanoue, Remarks before the Conference of State Bank Supervisors (May 12, 2000), available at http://www.fdic.gov/news/speeches/chairman/sp12May00.html (last modified May 12, 2000) [hereinafter Tanoue May Remarks].
\item \textsuperscript{75} Id.
\item \textsuperscript{76} Id.
\end{itemize}
losses between $750 million and $850 million. The largest portion of the loss, approximately $500 million, appears to come from improperly recorded assets that did not belong to Keystone. The remainder of the losses came from improperly valued retained interests. Keystone originated sub-prime and high loan-to-value loans, pooled them, and then securitized the loans. Due to the sub-prime quality of the loans, Keystone was required to provide credit supports to the general investors and "retained interests" in the securitization to absorb first losses of any defaults.

As intended, Keystone's retained interests absorbed the credit losses, reducing the asset value of the retained interests, as some of the loans in the securitized pools began to default, and the retained interests were liquidated to support the securitization. It is expected that between $340 million to $370 million of the Keystone's total $380 million retained interest position will be lost.

The other failure that concerned regulators was PTL, which had $118 million in assets. PTL originated subprime mortgages that it sold to its parent company. PTL shared in the cash flow from the resulting securitization with its parent company and retained interests of approximately $50 million from these securitizations on PTL's books. The records indicate that the

77. Tanoue Feb. Testimony, supra note 50, at 12.
78. Id.
79. Id.
80. Id.
81. Id. This is a form of credit enhancement that many securitization structures use to support a higher credit rating on other portions of the securitization that are sold to investors. Therefore, the retained interest is structured to be the first loss position to absorb defaults and its valuation can be volatile depending on the payment experience of the pool. See id.
82. Id. No corresponding entries were make to revalue the retained interests after they were initially booked on the banks balance sheets as assets. Id. The diminution in value was not represented as a reduction in capital, and it appeared that the bank had adequate resources to handle a business crisis. Id.
84. Id.
85. Id.
86. Id. PTL did not receive any payments in the early years of the securitization so it did not have sufficient operating income to pay operating expenses. Id. Therefore, in order to generate cash flow, PTL's parent borrowed up to 75% of the estimated value of the retained interest and passed the funds on to PTL. Id. The borrowings were to be repaid from the excess interest due to PTL and its parent. Id.
pre-payments and losses in the underlying loans exceeded the assumptions made in the valuations of the retained interests. There is little or no chance of PTL or the FDIC receiving any payments on these retained interests.

Retained interests are booked on a bank's balance sheet as assets, even though they may not have any actual verifiable value, thereby increasing aggregate capital levels. As a bank continues to retain interests in future securitizations, the overall asset level of the bank may appear to be increasing, but in reality the underlying asset base may be declining in quality and actual value. Keystone and PTL demonstrate how booking retained interests on the bank's balance sheet distort the meaningfulness of capital ratios. The retained interests were not properly valued, which gave the illusion of well-capitalized institutions. In reality, the banks were on the verge of insolvency with significantly overvalued assets.

After the failures of Keystone and PTL, regulators view retained interests as highly volatile assets that require more rigorous capital treatment and regulatory scrutiny. Recent examinations reveal that there are other institutions on the FDIC problem list. Additionally, there are a number of institutions that are not on the problem list but that are holding more residual interests in securitized assets than the FDIC believes is prudent. The regulatory agencies are thus moving to implement changes in

However, PTL stood sixth in line for any payments: first they went to scheduled principal and interest, second to fund delinquencies and defaults, third for monthly fees and servicing, fourth to funds required for reserve balances, fifth to payments on the borrowings of PTL against the advance on the retained interests loan, and finally, if any payments remained, to PTL. Id. at 13. The FDIC believes that the $50 million retained interests shown as assets on the PTL banking books are probably worthless and will result in a zero recovery at a total loss rate of approximately 40%. Id.

87. Id.
88. Id.
89. Tanoue May Remarks, supra note 74, at 1.
90. Id. Because capital is one of the main levers for controlling growth, unrealistic assumptions can lead to catastrophic losses and insolvency. Id.
91. Id.
92. Id. at 1.
93. Id.
94. Id at 3.
95. Tanoue May Remarks, supra note 74, at 3.
96. Id.
the way residual interests are valued.\footnote{Id.}{The trend is toward restricting banks from holding excessive concentrations of residual assets. Id.}\footnote{98.}{See Interagency Guidance 1999, supra note 5, at 1.}\footnote{99.}{Id.}\footnote{100.}{March 2000 Proposal, supra note 6, at 12,320.}\footnote{101.}{Press Release, FRB, FDIC, OCC, and OTS, Agencies Propose Revision of Capital Rules for the Treatment of Residual Interests (Sept. 27, 2000), available at http://www.federalreserve.gov/boarddocs/press/boardacts/2000/20000927/default.htm. (last visited Feb. 27, 2001).}\footnote{102.}{Id.}\footnote{103.}{Interagency Guidance 1999, supra note 5, at 1.}\footnote{104.}{Id. at 2.}\footnote{105.}{Id. at 1.} Retained interests are those rights to cash flows and other assets not used to extinguish bondholder obligations and pay credit losses, servicing fees and other trust fees, and include over-collateralization, spread accounts, cash collateral...
The March 2000 rules, which closely followed the December letter, proposed amending the risk-based capital standards for certain recourse obligations, direct credit substitutes, and securitized transactions. The proposal involves detailed changes to various aspects of the securitization process and introduces the use of ratings agencies as a way to objectively measure credit risk.

The main components of the March 2000 proposed regulation would:

1. Assign a risk-based charge to positions in securitized transactions according to the relative credit risk of those positions as measured by credit ratings received from nationally recognized rating agencies.

accounts, and interest only strips (IO strips). Id.

106. March 2000 Proposal, supra note 6, at 12,319. Mr. Hahn said his sense is that some regulation will result from this proposal although the final form has not yet been determined. Telephone Interview with Robert Hahn, attorney with Kilpatrick Stockton, LLP (Oct. 13, 2000). The current proposal is the culmination of years of effort by the agencies to develop a method to establish appropriate levels of capital for banking organizations relative to their risk exposure from recourse and direct credit substitutes. Id.

107. March 2000 Proposal, supra note 6, at 12,319. The first regulatory effort to address the capital requirements for recourse and direct credit substitutes occurred in June 1990. See 55 Fed. Reg. 26,766 (June 29, 1990). In 1994, another proposal was floated. 59 Fed. Reg. 27,116 (May 25, 1994). Again, on November 5, 1997, the agencies published another proposed Risk-Based Capital Standards: Recourse and Direct Credit Substitutes, 62 Fed. Reg. 59,944 (Nov. 5, 1997). The capital reduction for low level recourse transactions and defining “recourse,” and “direct credit substitute” was eventually implemented by the OCC, The Board and the FDIC in 1995. Id. Part of the incentive to pass the section of the rule making notice was the requirement for the agencies to satisfy the requirements of section 350 of the Riegle Community Development and Regulatory Improvement Act, Public Law 103-325, § 350, 108 Stat. 2160, 2242 (CDRI Act). Id. This proposed regulation was the 1997 Proposed 62 Fed. Reg. 59,944. Id.

108. March 2000 Proposal, supra note 6, at 12,323. The ratings can be done by any “nationally recognized statistical rating organization,” this means any entity such as Standard & Poor’s, Moody’s or Fitch. Id. at n.13. See SEC Rule 15c3-1(c)(2)(vi)(E), (F) and (H), 17 C.F.R. 240.15c3-1(c)(2)(vi)(E), (F), and (H). The table below shows the resulting capital requirements for recourse obligations, direct credit substitutes, and senior and subordinated securities in asset securitizations. Id. See also Basel 1999 Proposal, supra note 3.
2. Treat recourse obligations and direct credit substitutes more consistently under risk-based capital rules.\textsuperscript{109}

3. Define "recourse"\textsuperscript{110} and revise the definition of "direct credit substitute."\textsuperscript{111}

4. Permit the limited use of an institution's internal risk-rating system and other alternative approaches in determining the risk-based capital requirement for unrated direct credit substitutes associated with asset-backed commercial programs and other structured finance programs.\textsuperscript{112}

5. Require banking organizations to hold additional risk-based capital against risks presented by the

<table>
<thead>
<tr>
<th>Rating Category</th>
<th>Examples</th>
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<tr>
<td>Highest or second highest investment grade</td>
<td>AAA or AA</td>
<td>20%</td>
</tr>
<tr>
<td>Third highest investment grade</td>
<td>A</td>
<td>50%</td>
</tr>
<tr>
<td>Lowest investment grade</td>
<td>BBB</td>
<td>100%</td>
</tr>
<tr>
<td>One category below investment grade</td>
<td>BB</td>
<td>200%</td>
</tr>
<tr>
<td>More than one category below investment grade, or</td>
<td>B or unrated</td>
<td>&quot;Gross-up&quot;</td>
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* Gross-up treatment takes the position and combines it with all more senior positions in the transactions, resulting in a risk-weighting based on the nature of the underlying assets. \textit{Id.}

\textsuperscript{109} March 2000 Proposal, \textit{supra} note 6, at 12,323.

\textsuperscript{110} \textit{Id.}

\textsuperscript{111} March 2000 Proposal, \textit{supra} note 6, at 12,323; \textit{supra} note 6 (defining direct credit substitutes).

\textsuperscript{112} March 2000 Proposal, \textit{supra} note 6, at 12,323. Banking organizations with a qualifying internal risk rating system can use that system to their un-rated direct credit substitutes in asset-backed commercial paper programs. \textit{Id.} Internal risk ratings can be used for a risk weight of 100\% or 200\% under the ratings-based approach, but not for a risk weight of less than 100\%. \textit{Id.} This will allow institutions to avoid costly gross-up treatment that would apply to an un-rated position. \textit{Id.} The agencies feel that an internal risk rating approach may be less costly than a ratings-based approach that relies exclusively on ratings from external rating agencies for the risk-weighting of these positions. \textit{Id.}
early amortization of revolving asset securitizations.\textsuperscript{113}

On September 28, 2000, the agencies jointly proposed to amend the capital rules for the treatment of residual interests.\textsuperscript{114} This was done despite the fact that the regulations proposed in March 2000 regarding the treatment of certain recourse obligations, direct credit substitutes, and securitized transactions were still being debated.\textsuperscript{115}

The new rule proposes to align risk exposure with regulatory capital requirements, encourage conservative valuation methods, and restrict the concentration of these residual interests on a bank's balance sheet.\textsuperscript{116} Residual interests in the September proposal are defined as those on-balance sheet assets that represent interests (including beneficial interests) in the transferred financial assets retained by the bank (or transferor)

\textsuperscript{113} Id. at 12,323. Early amortization features are structured into some securitization transactions in order to ensure that investors will be repaid before being subject to the risk of credit loss. Id. There are three distinct risks to the bank, first the seller's interest is subordinated to the interest of the investors by the payment allocation applied during early amortization. Id. The Investors will get paid first, so the bank's residual interest will absorb a disproportionate share of credit losses. Id. Second the early amortization can create liquidity problems for the seller. Id. Third the first two risks can create an incentive to provide implicit recourse to prevent early amortization. Id. In order to account for these risks the agencies would require that the securitized off-balance sheet assets to receive a 20% risk category, effectively applying a 1.6% risk-based capital charge to these off balance sheet assets. Id.

\textsuperscript{114} September 2000 Proposal, supra note 6, at 57,993. FASB has initiated Rule 140 which requires two sets of disclosures where an issuer retains an interest in a securitization and records the transaction as a sale and the assumptions used in valuing the residuals, such as the discount rates, prepayment rates and anticipated losses. Brian Collins, Regulatory Watch: FASB Issues New Version of Rules for Accounting of Servicing Transfers, MORTGAGE SERVICING NEWS, Nov. 2000, at 22. The banks will also have to report cash flows between the retained interests and the mortgage trusts, if key assumptions have changed, and finally show how the retained assets would perform under stress tests. Id. "Demands on FASB to develop better disclosure methods for residuals started in 1998 after several publicly traded subprime lender that abused gain on sale accounting failed." Id. The Bond Market Association "complained that FASB is penalizing the entire industry for the actions of a small number of subprime lenders." Despite this opposition the new rules went into effect December 15, 2000. Id.

\textsuperscript{115} March 2000 Proposal, supra note 6, at 12,323.

\textsuperscript{116} September 2000 Proposal, supra note 6, at 57,993.
after a securitization. The residual interests subject to this proposal are structured to absorb more than a pro rata share of credit loss related to the securitized or sold assets by utilizing subordination provisions or other credit enhancement techniques. Residual interests provide a unique challenge to valuation because of their illiquid and volatile nature.

There are three components to the new rule. The first changes the leverage and risk-based capital requirements by requiring that financial institutions set aside dollar-for-dollar risk-based capital equal to the amount of the residual interest retained on a bank's balance sheet. For example, suppose an institution participates in a securitized transaction for a total of $100 million and records a residual interest of $5 million. Under the “low-level recourse rule,” the institution would be required to hold either a dollar-for-dollar capital charge to a maximum level of 8%; therefore, the bank would be required to hold $5 million of regulatory capital for the transaction. Now assume that the bank has instead retained $15 million in retained residual interests on the same $100 million transaction. Under the current rules the bank is only required to hold regulatory capital up to 8%, which

117. *Id.* Examples of residual interests include, but are not limited to, interest only strips receivable (I/O strips), spread accounts, cash collateral accounts, retained subordinated interests, and other similar forms of on-balance sheet assets that function as a credit enhancement. *Id.* “Residual interests as defined in the proposed rule, do not include interests purchased from a third party.” *Id.*

118. *Id.* at 57,997. The interests covered by this rule are generally retained by the selling institution because they are usually illiquid and volatile. *Id.* The rule extends to all residual interests, as defined in the banking book and the trading book, that are subject to market risk rules. *Id.* This rule only applies to residual interests that have been retained by the institution and does not apply to residual interests that a banking organization purchases from another party. *Id.* However, the agencies are considering including some purchased interests within the scope of the proposed rule and are requesting comment. *Id.*

119. *Id.* at 57,993. Since residual interests generally do not have an active market, they do not have an easily ascertainable market value. Therefore, the financial institution must estimate the value of the residual interest. *Id.*

120. *Id.*

121. *Id.* The proposal also has some tax treatment considerations and seeks industry input on how to determine the level of complexity that should be applied to determine a net-of-tax treatment for residual interests. *Id.*

122. *Id.* at 57,993.


124. *Id.*
would be $8 million, even though the bank is exposed to a credit risk of $15 million.\(^{125}\) If the bank has to write down the asset from $15 million to $5 million, the $8 million of required capital would be insufficient to absorb the full loss of $10 million.\(^{126}\) Removal of the current "cap" of 8% will ensure that all residual interests are subject to the "dollar-for-dollar" standard and that the capital held represents the organization's total exposure for loss.\(^{127}\)

The second part of the new rules proposes to restrict concentrations of residual interests held on an institution's balance sheet to no more than 25% of Tier I capital.\(^{128}\) This limit should prevent banks from holding excessive concentrations of residual interests.\(^{129}\) The September 2000 proposal could significantly impact the capital treatment of many institutions participating in securitizations and determine the feasibility of certain types of transactions pending the implementation of this rule.\(^{130}\) The agencies believe that this proposal should help remedy some of the major regulatory concerns about the illiquid and volatile nature of residual interests.\(^{131}\)

The third component of the rule concerns regulatory authority.\(^{132}\) The agencies have added language to these risk-based

\(^{125}\) September 2000 Proposal, supra note 6, at 57,996. The rule is intended with the two prong approach to ensure that residual interests are supported by "dollar-for-dollar" capital and that financial institutions will avoid the concentration of residual interests on the balance sheet of over 25% of capital because of the harsh regulatory treatment relative to capital. \(\textit{Id.}\)

\(^{126}\) \(\textit{Id.}\)

\(^{127}\) \(\textit{Id.}\)

\(^{128}\) \(\textit{Id.}\)

\(^{129}\) September 2000 Proposal, supra note 6, at 57,996. The rule is intended with the two prong approach to ensure that residual interests are supported by "dollar-for-dollar" capital and that financial institutions will avoid the concentration of residual interests on the balance sheet of over 25% of capital because of the harsh regulatory treatment relative to capital. \(\textit{Id.}\)

\(^{130}\) Scott Barancik, \textit{Agencies Say Small Banks' Securitizing Getting Risky, AM. BANKER}, Dec. 14, 1999, at 1. In fact, if bank examiners are successful in forcing banks to lower their residuals' value there could be some capital problems. \(\textit{Id.}\) Recently, the OCC deemed Goleta (Cal.) National Bank "significantly undercapitalized" because of residual values and ordered the institution to raise additional capital. \(\textit{Id.}\) These types of problems may not be isolated. \(\textit{Id.}\) According to the FDIC, eleven banks and thrifts nationwide have residuals that total at least 25% of equity capital and two of the four institutions whose residuals equaled 100% or more of the equity capital at midyear later failed: First National and Pacific Thrift. \(\textit{Id.}\) Mark S. Shmidt, Associate Director of Bank Supervisory Policy at the FDIC said the "poster children for these problems are First National Bank of Keystone, which failed Sept. 1, and Pacific Thrift and Loan, a Woodside, California based institution that closed Nov. 19." \(\textit{Id.}\) at 1.

\(^{131}\) September 2000 Proposal, supra note 6, at 57,998.

\(^{132}\) \(\textit{Id.}\)
capital standards to provide them with extensive authority and flexibility to administer the capital standard because of the rapidly changing innovations in banking. The proposal would give the Agencies' authority, on a case-by-case basis, to determine the appropriate risk-weight of assets created during innovative securitizations, and assign corresponding capital requirements. They intend to retain sufficient discretion to ensure that institutions which develop novel financial structures will be treated appropriately under the risk-based capital standards.

The agencies recognize the controversies that surround the March proposal and the potential political fall-out of preemptively initiating regulations on recourse and direct credit substitutes while the Basel Committee works towards a final proposal. It is likely that there may be some delay in implementing the March proposal. However, the perceived danger to the financial system in light of the recent bank failures and the excessive concentrations of retained interests on bank balance sheets has fast-tracked the September proposal, despite considerable opposition. This momentum may help the agencies move forward with the September regulatory initiative independent of the March proposal.

V. ANALYSIS

The U.S. bank regulatory agencies are committed to protecting the banking industry from the perceived risk to the
industry from banks that participate in securitization activities. U.S. officials are not alone in this effort as industry leaders from around the world are working on global solutions to a myriad of problems to the evolving banking industry. Not surprisingly, the March 2000 proposal by U.S. agencies incorporates many of the proposals made in the revised Basel proposal of 1999.

Many in the community are strongly urging the agencies to delay implementing a final rule regarding capital for credit enhancements until Basel can ratify the new accord. The political fall-out from the international financial community could be great if the U.S. implements the March proposal. The U.S., as a major participant and architect of the Basel process, could undermine the significance of the accord, minimize the ultimate legitimacy of the final accord and marginalize the concerns, interests and comments of the other participants. Those who already question the "influence" of the U.S. over the Basel process would view any move on the part of the U.S. as a preemptive maneuver to effectively make those portions of the continuing dialogue and input from other countries meaningless.

While most generally agree with the agencies' attempt to equalize the treatment of recourse interests, retained interests and credit enhancements, the timing of the implementation and structure of the regulations is of significant concern. The implementation of this policy should be considered in the context

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143. Boemio Interview, supra note 136.
144. Id. Once the U.S. committed itself to pursuing the adoption of a revision to the Basel Accord of 1989 it should not preemptively act to diminish the effectiveness of that effort.
145. Id.
of the necessity for banks to engage in regulatory capital arbitrage and the current regulatory capital requirements for on and off balance-sheet items.\textsuperscript{147}

The unilateral view of regulators that all regulatory capital arbitrage is bad should be tempered, especially in light of comments by Chairman Greenspan, who has indicated that such arbitrage "acts as a safety-valve."\textsuperscript{148} The regulators' view is especially unfortunate in cases where arbitrary on-balance-sheet regulatory capital requirements might preclude the bank from engaging in a low-risk, socially desirable lending activity (because returns to such regulatory capital would be too low).\textsuperscript{149} This is a compelling argument for social good; however, most securitizations are not done to further public policy but are intended as vehicles to maximize profits in the institution. Perhaps more appropriate is the argument that the current capital charges are significantly in excess of best-practice estimates for appropriate economic capital; therefore, banks must participate in securitizations when "best-practice internal procedures for allocating capital" are not applied.\textsuperscript{150}

Another concern is that regulators are setting capital requirements, wherever possible, based on a rigorous standard for bank soundness.\textsuperscript{151} Under modern economic capital measurement techniques, this type of rule should provide regulators with specific guidance as to appropriate minimum capital levels.\textsuperscript{152} However, instead of evaluating a portfolio, the agencies appear to be content with setting capital requirements in the ordinal fashion, with each proposal based on capital being either higher or lower that the standard eight percent requirement found in the Accord.\textsuperscript{153}

\textsuperscript{147} Id.
\textsuperscript{148} Id. at 3-4.
\textsuperscript{149} Id. Banks that engage in sub-prime loans to segments of the market that would otherwise be unable to access financing may be restricted from continuing to provide loans if they are unable to securitize and reduce the level of "higher risk loans" from their balance sheets. This is a sensitive subject as there is significant movement to increase the participation of historically marginal homebuyers, yet these regulations may be at cross purposes with that policy.
\textsuperscript{150} Id. at 4.
\textsuperscript{151} Basel 2001, supra note 142, at 4.
\textsuperscript{152} Id.
\textsuperscript{153} Id.
The March proposal builds upon the earlier Basel Accord and continues a simplistic approach for setting capital requirements for credit risk.\textsuperscript{154} This approach ignores the fact that the risks of individual assets should be correlated with other assets in a firm's portfolio.\textsuperscript{155} As an example, one bank has all its loans committed to highly-rated firms, but they are all in the oil and gas industry, while the other bank has a loan portfolio of highly-rated firms diversified across industries; yet the current proposal that only looks to individual borrowers would impose the same requirements on both institutions.\textsuperscript{156} This type of approach holds little promise of providing an accurate measure of an institution's overall risk and does not solve the problem of continued capital arbitrage.\textsuperscript{157}

The proposal retains the "risk bucket" approach for establishing capital requirements.\textsuperscript{158} This approach ignores modern portfolio management techniques, which dictate that the determination of the true riskiness of a portfolio must be based on an over-all view of the portfolio of assets, liabilities, and off-balance-sheet risks, rather than an isolated view of individual assets.\textsuperscript{159}

A recent study of the Basel Accord confirms that the current standards have failed to limit bank default risk or to provide an accurate assessment of bank asset risk. Banks were apparently encouraged to assume greater leverage once the standards were in place.\textsuperscript{160} This begs the question, will layering more complex capital levels fix what may be an inherently faulty assumption that bank solvency is best protected through the


\textsuperscript{155} Id.

\textsuperscript{156} Id.

\textsuperscript{157} Id.

\textsuperscript{158} Calomiris & Litan, supra note 43, at 311. The new proposal in setting relative rankings of risk categories may introduce more arbitrariness into the process and may be no better at allocating capital for the risk to the banking institution. \textit{Id.} This is not just a technical objection because by failing to measure overall portfolio risks, the proposal does not encourage banks to target the appropriate amount of capital to compensate for the risks they are taking. \textit{Id.}

\textsuperscript{159} Id.

\textsuperscript{160} Id.
imposition of capital levels?\footnote{161}

Giorgio Szego, professor of mathematical finance at the University of Rome, proposes that the current minimum capital ratio is not risk adjusted but liquidity adjusted and that the main cause of bank failures is loan concentration, not inadequate capital levels as assigned by the Basel committee.\footnote{162} "In an interview given in 1996, Mr. Peter Cooke, the historical chairman of the Basel committee, stated, 'Capital was a singularly convenient and useful element of banking business for regulators to seize upon and legislate over.'"\footnote{163}

Both proposals are likely to draw intensive debate but regulators want to implement the September proposal, because they believe that the retained interests from securitizations are the most potentially dangerous forms of recourse arrangements that a bank can hold after a securitization.\footnote{164}

The bankers are openly critical of the September 2000 proposed rule, complaining that it is too broad, contradicts other proposals, and is punitive and unnecessary.\footnote{165} Bankers feel that the regulators are responding to isolated problems with residuals and overreacting with inconsistent rules.\footnote{166} A joint letter from several large banks states that the supervisory concerns that led to the September proposal should not invalidate the years of work and study reflected in both the March 2000 proposal, and the Basel proposal.\footnote{167} A main complaint is the lack of differentiation among retained interests based on credit quality and that the proposal attempts to force a one-size fits all approach as a solution to the residual interest problem.\footnote{168}

\footnote{161. See generally id.} 
\footnote{162. SZEGO, supra note 9, at 152.} 
\footnote{163. Id. at 153.} 
\footnote{164. Garver, supra note 25, at 3.} 
\footnote{165. Id.} 
\footnote{166. Id.} 
\footnote{167. Id. For example, the March proposal would reduce capital requirements for a retained subordinated interest that receives a high rating from a rating agency. Id. The residual proposal does not recognize the difference of potential credit quality of interests and assigns the same capital regardless of the rating of the interest. Id. So while the March proposal would assign a different capital level the September proposal would not, therefore leading to conflicting treatments under the regulatory scheme. Id.} 
\footnote{168. Id.}
Opponents to the proposal contend that all residuals are not the same, nor are they valued the same way. While some residuals are susceptible to overly aggressive valuations, others have definite values. For example, some residuals with definite values that are not subject to change in value based upon assumptions are cash assets from spread accounts, subordinated securities, and retained portions of sold assets; however, these assets will be treated exactly the same way as highly volatile retained interests.

Bankers also argue that since the problem is limited to a small number of banks, the agencies should, within their discretion, look at those individual banks. In fact James E. O’Connor, tax and accounting council for America’s Community bankers wrote:

Given the supervisory option of imposing individual minimum capital requirements on any entity where there is an undue exposure not captured by the overall risk-based approach, it is not clear why this individualized approach could not be substituted for the entire complex apparatus of the proposed rule.

Despite industry objections, the agencies appear to be determined to initiate some form of regulatory action concerning retained interests. However, the agencies continue to point to the recent failure of several banking organizations that had residual interests exceeding the recommended concentrations of

169. Id. Several of the larger banks have invested significant time and money in developing systems that fluctuate in value as requested by the December Guidance letter. Id.

170. Garver, supra note 25, at 3.

171. Id. Mr. Wright, Vice Chairman and Chief Finance Officer of MBNA, writes that the proposal would “unfairly penalize banks, such as MBNA, that have developed and implemented a prudent securitization program.” Id. He further went on to say that “MBNA had securitized more than eighty eight billion dollars of credit card and other loans since 1986 and had never overvalued any residuals.” Id.

172. Id. Those banks that have implemented prudent investment and management practices to properly manage the risks of these types of securitizations should be encouraged, not burdened, with increased regulatory oversight. Id.

173. Id.

174. Id.
the proposed September 2000 rule. The agencies are especially concerned with smaller banks that are securitizing and holding residuals on their balance sheet. They feel that many institutions lack the market expertise and internal management controls necessary to fully appreciate and evaluate the impact of the activities on the soundness of the institution. Regulators are responsible for maintaining the safety and soundness of our financial institutions and they believe it is their responsibility to act when significant risks develop in the industry.

VI. CONCLUSION

Any financial institution can absorb some losses in retained interests and still maintain its solvency. More problematic is a bank that has not properly allocated capital for its risks and continues to maintain high concentrations of retained interests relative to the rest of its assets. An institution like this will be at a greater risk to fail, as evidenced by the experience at both Keystone and PTL.

Banks meanwhile continue to structure securitizations so that they can exploit the anomaly of the regulation. In doing so, they potentially put the soundness of their financial institution at risk by excessively leveraging the institution. While during good economic times this may seem to be a sustainable activity, in the

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175. Id.
176. Garver, supra note 25, at 3. The problem with many of these banks is that they are at a disadvantage because they do not have the diversification of assets and are more likely to have large concentrations of these residuals combined with the lack of efficient risk management policies. Id. This creates a problem that a bank doesn't understand the value of the residuals, may over value them and then when a credit problem occurs there is insufficient capital to absorb the credit loss and the bank faces insolvency. Id.
178. Boemio Interview, supra note 136. A concern of regulators is the similarities they see between the balance sheets of banks holding retained interest and the failures of New England thrifts in the late 1980s. Id. The structures and concentrations of "sub-prime loans" that created phantom income and asset values during the eighties appears similar to the effect that residual interests have on bank balance sheets today. Id.
179. See generally Interagency Guidance 1999, supra note 5.
event of an economic downturn with increased loan losses and decreased business activity, it may well make the difference between an institution that can survive the losses and one that becomes insolvent.

When a bank holds a large portion of retained interests as assets on its balance sheet as traditional capital reserves, the underlying risk and capital adequacy assumptions become invalid. This is why the losses experienced at Keystone and PTL exceeded historical norms and the BIF was faced with bailout costs far in excess of the traditional bank failure.

The September 2000 proposal intends to discourage this type of regulatory capital arbitrage and the concentration of retained interests as a bank asset.181 Perhaps the framework of a dollar for dollar set aside and the 25% concentration limit appears excessive.182 There may be room for discussion and some refinement of the structure of the regulation.183 What appears to be clear, however, is that the agencies perceive this issue to be one that requires immediate and decisive intervention to prevent more bank failures similar to Keystone and PTL.184

The implementation of any proposal requires a delicate balancing act between overly burdensome regulation and the need to protect the safety and soundness of our banking system verses the innovations of the marketplace and the necessity of banks to effectively compete and maintain profitability.185 Alan Greenspan spoke about the regulatory and supervisory challenges facing the industry as we enter the new century at a recent speech to the ABA convention in September of 2000.186 During the speech he stated:

181. Boemio Interview, supra note 138.
183. Boemio Interview, supra note 138.
184. Id.
185. Id.
rapidly changing technology has begun to render obsolete much of the bank examination regime... have required federal and state examiners to focus supervision more on risk-management than on actual portfolios... today's products and rapidly changing structures of finance mean that supervisors are backing off from detail-oriented supervision, ... toward a system in which we judge how well your internal risk models are functioning and whether the risk... is being appropriately managed and offset with capital... how to blend functional regulation and umbrella supervision.187

As market forces continue to shape the dialogue between regulators and banks, both will be required to challenge the existing system to create a banking industry able to compete in the new economy.188

The international initiative headed by the Basel Committee has undertaken the massive task of establishing global standard for banking supervision and regulatory oversight with anticipated implementation of a new Accord sometime in 2004.189 The initial comment period generated more than 200 responses.190 After additional discussions with the industry and reviewing the comments the Committee released a more concrete proposal in January 2001, seeking final comments before May 31, 2001 and anticipating that the final form of the proposal will be available toward the end of 2001.191

As the Basel proposal moves forward toward its final form, the innovations in the marketplace will continue and the standards of today may not meet the requirements of tomorrow's financial marketplace.192 Attempts to refine the standards inevitably will lag fast-paced market developments; therefore, flexible and

187. Id.
188. Id.
190. Id.
191. Id.
responsive standards must be an important component of any Accord. 193

The proposed U.S. rules are presently in limbo, the comment period has ended for the March 2000 proposal and the comment period closed in December for the proposed September 2000 rule. 194 It appears that the prevailing sentiment may well be to wait until the Basel Committee finalizes the Capital Adequacy Proposal before implementing the March rule. 195

As we look at these initiatives, we have many unanswered questions. It remains to be seen what ultimate form these regulatory initiatives will take. It is unquestioned that supervisors across the globe are committed to initiating new standards to deal with the vastly different banking and financial markets that exist today. 196

The markets want a regulatory scheme reflective of the realities of the marketplace that will allow growth and innovation. Of significant concern to the banking industry, however, is the capital treatment of securitizations in the various proposals. Over the past decade securitization has contributed to the liquidity of the capital markets and to our economic growth. "The ability of banks to sell pools of loans into the capital markets enhances the efficiency of the lending process." 197 Overly burdensome regulatory requirements could negatively impact this important tool and reduce the liquidity of the marketplace and profitability of well-managed banks.

We do not know if the new regulations, will work as intended. However, it is clear that the existing regulations and rules are unable to accurately access the health of our financial institutions today. Change is a constant and the ability of our

193. Id.
194. Boemio Interview, supra note 138.
195. Id.
197. Robert J. Grossman, Securitize or Sink, J. LENDING & CREDIT RISK MGMT., Apr. 2000, available at http://www.rmahq.org/Join/AprilJournal/0400_09.html (last visited Feb. 27, 2001). Grossman makes the assertion that the old business model of originating loans and holding them on the bank's books is out of date. Id. Banks that securitize will be more profitable and be able to pick up market share from banks that choose not to securitize. Id.
supervisory agencies to adapt to the change is of critical importance to the future of banking. The challenge for our banking industry is the implementation of flexible and yet effective regulatory initiative. To quote Chairman Greenspan:

In 1875, the American economy and its banking industry stood on the threshold of a profound technological revolution that would challenge and enrich our nation in unimaginable ways. I believe that in the year 2000 we may well be on the cusp of a similar revolution. The banker of the nineteenth century met their many challenges and kept the banking industry a vibrant and critical part of the U.S. economy. I am confident that the bankers of the twenty-first century, though no less challenged, will prove no less capable.\footnote{Greenspan Sept. 2000 Speech, \textit{supra} note 186, at 5.}