DebtX
THE DEBT EXCHANGE

April 30, 2012

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: Docket No. 1438 and RIN 7100-AD-86 – Stress Test Requirement

Dear Sir or Madam:

The Debt Exchange, Inc. (DebtX) respectfully submits this letter to the Board of Governors of the Federal Reserve System in response to proposed rules that would implement the enhanced Prudential standards required to be established under section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Specifically, this commentary relates to the stress test requirement component of the enhanced standards applicable to companies that the Financial Stability Oversight Council has determined pose a grave threat to financial stability.

DebtX is the world's leading loan valuation and transaction specialist firm, providing analytics, loan sale advisory services, and software-as-a-service (SaaS) solutions for third parties managing their own loan sales and syndications. On a quarterly basis, DebtX provides mark-to-market values on nearly $1 trillion of loans and processes billions of dollars in loan sales and syndications through its online deal management platform. DebtX has valued and sold loans on behalf of hundreds of public and private entities, including the Federal Deposit Insurance Corporation for whom DebtX has provided such services since 2003.

DebtX's comments are intended to provide perspective on the merits of stress testing loans held in accrual portfolios using a mark-to-market approach in addition to traditional methodologies[1].

The use of mark-to-market to value loans has been a hotly debated topic. Proponents argue such disclosure provides transparency to balance sheets, improving comparability across financial institutions. Opponents believe mark-to-market is not relevant for assets held over the long term because pricing volatility and embedded inefficiencies in the marketplace can cause unacceptably large movements in price over a short period of time. Further, there is disagreement about the reliability of the models used to estimate fair market value.

DebtX believes the use of mark-to-market will complement traditional techniques and significantly enhance the value of the stress test results without negative side effects or significant cost. Utilizing algorithms based on and calibrated to actual third party loan trades mitigates potential concerns related to model reliability.

[1]Traditional stress test models typically involve estimating losses under varying macroeconomic conditions based on historical borrower behavior and loss experience and/or projected LGD (loss given default) and PD (probability of default) over time.

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Adopting a mark-to-market loan valuation methodology in the stress tests will help unmask potential weaknesses within individual banks' loan portfolios during times of economic turmoil. Management can use this information to identify which segments of the portfolio are most at risk, and take steps to mitigate their exposure. Mark-to-market stress tests provide information on the risk/return dynamic, specifically measuring the change in market value due to market conditions and the degree to which the portfolio risk is offset by the potential of interest earned. Use of stress tests results can help banks understand the impact on their portfolios due to rising interest rates - with or without a credit-based shock - and the potential for a liquidity squeeze due to declining loan value.

Mark-to-market in stress tests will also provide a measurement of the ability for the banks to raise required capital through the sale of loans. Banks can use stress test results to anticipate which segments of their portfolios may be most advantageous to jettison, better preparing themselves for business cyclicality. Marking-to-market under the stress scenarios provides information regarding the adequacy of loan loss reserves by assessing the relationship between reserves and market value as the economy hypothetically deteriorates. Utilizing mark-to-market in stress testing supports active portfolio management by helping banks identify risks to which they may take prompt corrective actions. This better prepares them for and insulates them from adverse economic shock.

Regulators could use the information from the mark-to-market stress tests to better understand the estimated cost of future bank failures. It is highly likely that loan holdings from failed banks will be sold to an acquiring institution or liquidated in the open market. A direct estimate of fair market value of all of the loans under various economic scenarios is the most relevant methodology for measuring expected selling price. Regulators can use aggregate results from mark-to-market stress tests to help determine whether insurance premiums and reserve levels are adequate to cover potential losses in the case of a credit or interest rate shock. In sum, use of mark-to-market stress tests can help regulators maintain stability and public confidence in the nation's financial system.

Resistance from bankers toward conducting mark-to-market analysis should be muted, particularly if the results are not disclosed publicly. If results are disclosed, the hypothetical estimates of value under various stress cases should cause no more angst than the balance of the stress test reports because the results have no direct economic impact. In a stress case scenario, hypothetical mark-to-market results will not affect a bank's balance sheet.

The procedures for marking-to-market are already in place. Publicly traded banks currently disclose baseline mark-to-market values on their accrual portfolio loans via fair value[2] footnotes to financial statements. And under current stress test protocol, mark-to-market techniques are used to value loans classified as held-for-sale and those to which the fair value option accounting rules are applied. Further, many banks' accrual portfolio loans are marked-to-market by third parties. Federal Home Loan Banks and other warehouse lenders routinely estimate current market value for loans pledged as collateral. *Overlaying stress test parameters atop existing mark-to-market models should not present a significant burden in terms of either time or cost.*

[2]While mark-to-market and fair value are often thought of as interchangeable terms, they are not. When reporting fair value, accounting rules allow banks to deviate from true market prices under certain circumstances, including periods of material market volatility. As such, fair value is a more broadly defined term than is mark-to-market. However, in the current economic environment where the market is considered relatively efficient and stable, figures reported in fair value footnotes should approximate mark-to-market estimates.

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As use of mark-to-market increases, so does the validity of the models. Indeed, any measurement of loan value or credit loss in a hypothetical stress case is subject to debate; DebtX believes its mark-to-market models and associated stress tests are at least as predictive as the traditional approaches. The best valuation techniques are highly scalable, loan-by-loan assessments using algorithms based on and calibrated to actual third party loan trades. In recent years, the availability of third party trade data has increased dramatically, driven in large part by the volume of loans sold in the secondary loan market both from failed banks and from other banks engaged in active portfolio management. Throughout the recent economic downturn, the substantial volume of loan sales by the FDIC and others has generated a significant volume of relevant data on which to base pricing models. Further, loan sale activity for all loan types across the performance spectrum is increasing, providing liquidity and establishing market-clearing prices.

DebtX appreciates the opportunity to share its perspective on the proposed rule. We believe the inclusion of mark-to-market in stress tests for banks' accrual loan portfolios will provide supplemental information which, when viewed in conjunction with the other techniques currently in place, will provide a more complete assessment of banks' health.

Sincerely

Bruce Hounsell
Executive Vice President