



FEDERAL RESERVE BANK  
OF DALLAS

WILLIAM H. WALLACE  
FIRST VICE PRESIDENT  
AND CHIEF OPERATING OFFICER

July 27, 1990

DALLAS, TEXAS 75222

Circular 90-51

**TO:** The Chief Executive Officer of each  
member bank and others concerned in  
the Eleventh Federal Reserve District

**SUBJECT**

**Request for Comment on Recourse Arrangements**

**DETAILS**

The Federal Financial Institutions Examination Council (FFIEC) has requested public comment on the definition of "recourse" and the appropriate reporting and capital treatments to be applied to recourse arrangements. Comment is also requested on how recourse arrangements should be treated under the lending limits applicable to banks and savings associations. The comment period ends August 28, 1990.

The five agencies represented on the FFIEC are considering the issuance of regulations or guidelines that would deal with the regulatory capital treatment of, and revise the reporting standards for, recourse arrangements for depository institutions and bank holding companies. The agencies have targeted year-end 1990 as the effective date for any changes to the regulatory treatment of recourse arrangements.

**ATTACHMENT**

A copy of the FFIEC's Federal Register notice is attached.

**MORE INFORMATION**

For more information, please contact Jane Anne Schmoker at (214) 651-6228. For additional copies of this circular, please contact the Public Affairs Department at (214) 651-6289.

Sincerely yours,

A handwritten signature in cursive script that reads "William H. Wallace".

## FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

### Recourse Arrangements

**AGENCY:** Federal Financial Institutions Examination Council.

**ACTION:** Request for comment.

**SUMMARY:** The five member agencies of the Federal Financial Institutions Examination Council (the "FFIEC"), which include the Board of Governors of the Federal Reserve System ("FRB"), the Federal Deposit Insurance Corporation ("FDIC"), the National Credit Union Administration ("NCUA"), the Office of the Comptroller of the Currency ("OCC"), and the Office of Thrift Supervision ("OTS") (collectively, the "Agencies"), are considering issuing regulations or Guidelines to address the regulatory capital treatment of recourse arrangements for depository institutions and bank holding companies. The Agencies are also considering revising the regulatory reporting requirements applicable to asset transfers with recourse and revising the lending limit treatment of recourse arrangements for national banks and savings associations. The Agencies plan to work together to develop common definitions and treatments of recourse arrangements, where appropriate.

"Recourse" refers to a financial institution's acceptance, assumption or retention of some or all of the risk of loss generally associated with ownership of an asset, whether or not the institution owns or has ever owned the asset. As the primary federal

supervisors of insured financial institutions and bank holding companies, the Agencies have observed that recourse arrangements are occurring with increasing frequency, particularly in the context of asset securitization programs. The Agencies recognize that recourse arrangements impose risks on financial institutions and believe it appropriate to report the existence of these risks and to include these risks when evaluating capital adequacy.

The federal bank supervisory agencies (the FRB, the FDIC, and the OCC) and the NCUA have not previously provided a comprehensive regulatory definition of "recourse". The OTS, the federal supervisor of savings associations, has a definition of the term "with recourse" which it plans to amend through rulemaking action. See 12 CFR 561.55. In the interest of a uniform treatment, the Agencies are soliciting public comment on the definition of "recourse," and the appropriate reporting and capital treatments to be applied to recourse arrangements. Public comment is also requested on how these arrangements should be treated under the lending limits applicable to banks and savings associations. The Agencies are targeting December 31, 1990, as the date by which resulting changes in the regulatory treatment of recourse arrangements would become effective.

**DATES:** Comments must be received by August 28, 1990.

**ADDRESSES:** Comments should be directed to: Robert J. Lawrence, Executive Secretary, Federal Financial Institutions Examination Council, 1776 G Street, NW., Suite 850B, Washington DC 20006. Comments will be available for public inspection and photocopying at the same location.

**FOR FURTHER INFORMATION CONTACT:** At the FRB: Roger H. Pugh, Manager, Policy Development, Division of Banking Supervision and Regulation (202) 728-5883; Thomas R. Boemio, Senior Financial Analyst, Division of Banking Supervision and Regulation (202) 452-2982. At the FDIC: Robert F. Storch, Chief, Accounting Section, Division of Supervision (202) 898-8906. At the NCUA: Alonzo Swann, Director, Department of Operations, Office of Examination and Insurance, (202) 682-9640. At the OCC: Owen Carney, (202) 447-1901; Richard Cleva, Senior Attorney, Legal Advisory Services Division (202) 447-1883; or Laura H. Plaze, Senior Attorney, Legal Advisory Services Division (202) 447-1883. At the OTS: Robert Fishman, Senior Project Manager (202) 906-5672; Carol Wambeke, Financial Economist (202)

906-6758; Deborah Dakin, Regulatory Counsel (202) 906-6445.

### SUPPLEMENTARY INFORMATION:

#### Introduction

In its broadest terms, "recourse" refers to the acceptance, assumption or retention of some or all of the risk of loss generally associated with ownership of an asset. Recourse is not necessarily a function of ownership or prior ownership of an asset, nor does it arise only as an incident of an asset sale. Moreover, recourse may arise even without a contractual obligation.

For many financial institutions, recourse is most frequently associated with asset sales, and particularly with asset securitization programs. Loans, receivables or other assets are securitized by first combining similar assets in a pool and then selling to investors either securities that represent ownership interest in the pool or debt obligations that are serviced by the cash flow from the pool. Asset securitization has become increasingly popular, as in some cases it has enabled financial institutions and bank holding companies to remove assets, or portions of assets, from their books. Asset securitization may allow a financial institution to reduce the capital necessary to meet regulatory minimums or to reduce the total amount of outstanding loans to an individual borrower. Further, asset securitization can provide a financial institution a source of funds through the sale of its assets, which enables the institution to increase its liquidity. Asset securitization may also provide an additional source of continuing income to a financial institution that acts as servicer of a pool of securitized assets.

Early securitized programs, dating from the 1970's, were usually federally sponsored, and were generally intended to enhance the secondary residential mortgage market. Three federally-sponsored agencies, the Governmental National Mortgage Association ("GNMA"), the Federal National Mortgage Association ("FNMA"), and the Federal Home Loan Mortgage Corporation ("FHLMC"), were each provided statutory authority to guarantee the payment of principal and interest to investors in pools of qualifying residential mortgages. Generally, the Federal government may bear some of the risk of loss in these agency asset securitization programs, by providing federal insurance for certain of the underlying mortgages and through the GNMA guarantee, which is backed by the full faith and credit of the United States.

While the sale of loan participations has been a longstanding bank practice, during the 1980's, financial institutions began to securitize and sell an increasing variety of loan portfolios and other assets to a wider group of public investors. These asset securitizations differ from the Federally-sponsored agency programs in that they are not necessarily backed by Federal insurance or Federal guarantees. In order to market these securitized assets to investors, who demand a stable, predictably performing investment product, some financial institutions have provided assurances against virtually all risk or loss.

The Agencies have observed an increasing use and variety of recourse arrangements in asset securitization programs. Some financial institutions have provided assurances against risks of loss that extend beyond credit risk to include losses due to interest rate and prepayment risk, foreign exchange risk, liquidity and marketability risks, and risks associated with statutory or regulatory compliance or uninsurable hazards. The Agencies have also observed that some financial institutions have assumed risks of loss implicitly, without entering into explicit contractual recourse agreements.

The Agencies believe, and have previously stated their belief, that quantifiable risks to a financial institution should be supported by capital. See, e.g., OCC Final Rule Establishing Risk-Based Capital Guidelines, 54 FR 4168 (January 27, 1989) (codified at appendix A to 12 CFR part 3); FRB Final Rule Establishing Risk-Based Capital Guidelines, 54 FR 4186 (January 27, 1989) (codified at 12 CFR 208.13, appendix A to 12 CFR part 208, and appendix A to 12 CFR part 225); FDIC Final Policy Statement Establishing Risk-Based Capital Guidelines, 54 FR 11500 (March 21, 1989) (codified at appendix A to 12 CFR part 325); and OTS Final Rule on Risk-Based Capital, 54 FR 46845 (November 8, 1989) (codified at 12 CFR part 567) (collectively, the "risk-based capital standards"). While the risk-based capital standards in their current form focus primarily on credit risk, whether or not represented by an asset on the balance sheet, such standards embody the principle that all risks require capital support consistent with the degree to which they expose an institution to potential loss.<sup>1</sup> As recourse

arrangements expose a financial institution or bank holding company to the risk of loss generally, the Agencies believe that these arrangements should be supported by capital.

In addition, the Agencies believe that a financial institution's exposure to a particular borrower should be monitored and limited. This fundamental tenet of safety and soundness is a statutory requirement under Federal law for national banks and savings associations<sup>2</sup> and under state law for state-chartered banks. As certain recourse arrangements expose a national bank or savings association to the individual risks of an underlying borrower, the OCC and the OTS believe that these risks should be addressed in the calculation of loans outstanding to one borrower. The staffs of the FRB and the FDIC also believe that the state laws limiting loans outstanding from state-chartered banks to one borrower should address the risks posed by recourse arrangements.

While these positions are not new, the Agencies consider it timely and appropriate to examine the general issue of recourse arrangements and the regulatory treatments they should be accorded. The current reporting and capital treatments accorded recourse arrangements by the various agencies and the lending limit treatments applicable to recourse arrangements of national banks and savings associations are briefly summarized below. Following that discussion, the specific issues for comment are presented. Finally, all questions are listed in a summary section.

## I. Current Reporting Treatment of Asset Transfers With Recourse

### A. National Banks and Federally-Insured, State-Chartered Banks

National banks and federally-insured, state-chartered member and nonmember banks are required to file quarterly Reports of Condition and Income ("Call Reports"), reporting to the OCC, FRB and FDIC respectively. The FFIEC is responsible for developing the reporting rules. See 12 U.S.C. 3305.

renamed the Basle Committee on Banking Supervision). The international framework is described in a paper entitled the International Convergence of Capital Measurement and Capital Standards dated July 1988.

<sup>2</sup> See generally, 12 U.S.C. 84 (limiting the total loans and extensions of credit a national bank may have outstanding to one borrower at one time); 12 U.S.C. 1464(u), as added by the Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. 101-73, 301, 103 Stat. 183 (August 9, 1989) ("FIRREA") (providing that the lending limits applicable to national banks under 12 U.S.C. 84 shall apply in the same manner and to the same extent to savings associations).

Under the current reporting rules, which are contained in the Instructions for Consolidated Reports of Condition and Income ("Call Report Instructions"), the reporting treatment of an asset transferred subject to a recourse arrangement varies depending on the type of asset sold, whether the transfer is through a federally-sponsored agency program, and, in some cases, on the level of the risk of loss retained. The reporting rules have the effect of allowing some asset transfers with recourse to be reported as sales, while requiring others to be reported as financing transactions with the assets retained on the balance sheet.

The Call Report Instructions include a Glossary of terms and instructions for various supporting schedules, including Schedule RC-L, "Off Balance Sheet Items."<sup>3</sup> Together, the Glossary and Schedule RC-L establish four separate reporting treatments for asset transfers with recourse.

First, a general rule is provided for the transfer of most assets other than transfers involving the issuance of certificates of participation in pools of certain residential or agricultural mortgages. Under the general rule, an asset transfer may be reported as a sale only if two conditions are met: (1) The transferring bank must not retain any risk of loss from the asset transferred; and (2) the transferring bank must have no obligation to any party for the payment of principal or interest on the asset transferred. See Glossary, Call Report Instructions (entry for "Sales of Assets").

Next, two different rules are established for transfers involving the issuance of certificates of participation in pools of residential mortgages. See *id.*, "Participations in Pools of Residential Mortgages." If the participations are issued or guaranteed under specified GNMA, FNMA, or FHLMC programs, the Glossary states that a bank disposing of its mortgages through such programs may treat the transaction as a sale of the underlying mortgages. Banks report mortgage transfers through these government agency programs as sales even when the transfers are with 100% recourse. See *id.*, and Schedule RC-L, Item 9(a).<sup>4</sup>

<sup>3</sup> Schedule RC-L was previously named "Commitments and Contingencies." Effective March 31, 1990, this schedule was renamed "Off-Balance Sheet Items."

<sup>4</sup> Item 9 was numbered Memorandum Item 4 prior to the changes made to Schedule RC-L, effective March 31, 1990.

<sup>1</sup> The risk-based capital guidelines of the OCC, FRB and FDIC are based on the international framework for capital standards established in July 1988, by the Basle Committee on Banking Regulations and Supervisory Practices (since



A different treatment applies if the certificates of participation are privately issued by the bank. For these issuances, the bank's ability to treat the transfer of the underlying mortgages as a sale depends upon the level of risk it has retained. The Glossary provides that "[o]nly when the issuing bank does not retain any significant risk of loss, either directly or indirectly, is the transaction to be reported as a sale of the underlying mortgages by the bank." *Id.*<sup>6</sup>

Finally, Schedule RC-L establishes a fourth reporting treatment for an asset transfer with recourse that applies only to transfers of agricultural mortgage loans through a Farmer Mac certified program.<sup>6</sup> The instructions to Item 9(c)(1) of Schedule RC-L state that transfers of agricultural mortgage loans under a Farmer Mac program in which the bank retains a subordinated participation interest (a form of recourse), may be "reported as sales for Call Report purposes to the same extent that the transactions are reported as sales under generally accepted accounting principles ['GAAP']." In general, this means that the transfer may be reported as a sale only if the bank surrenders control of the future economic benefits from the asset, can reasonably estimate its probable loss under the recourse provision, has no obligation to repurchase the asset except pursuant to the recourse provision, and establishes a liability account or specific reserve to absorb the estimated loss.<sup>7</sup>

#### B. Savings Associations

The regulatory reporting of savings associations is provided to OTS on the Thrift Financial Report ("TFR"), an OTS form. Unlike the bank supervisory agencies' Call Report, which establishes special supervisory rules for reporting transfers of four different types of assets with recourse, the TFR generally

requires savings associations to report these transactions in accordance with GAAP. In general, this means that a savings association may report an asset transfer with recourse as a sale only if the institution surrenders control of the future economic benefits from the asset, is able to reasonably estimate its probable loss under the recourse provision, has no obligation to repurchase the asset except pursuant to the recourse provision, and establishes a liability account or specific reserve to absorb the estimated loss.

## II. Capital Treatment of Recourse Arrangements

### A. Current Leverage Ratio Requirements

Under the current leverage ratio capital requirements of the FRB, the FDIC, and the OCC, the treatment of an asset transferred with recourse is directly related to the reporting treatment of the transfer.<sup>8</sup> Simply speaking, for national banks and federally-insured, state-chartered member and nonmember banks, if an asset transfer is reported as a sale, no capital support is explicitly required for the asset as a function of the current leverage ratios.<sup>9</sup> Consequently, because

<sup>6</sup> The risk-based capital guidelines issued by the FRB, the FDIC and the OCC in early 1989 will be phased in over a two-year transitional period beginning December 31, 1990. Proposed new leverage ratios are discussed *infra*.

<sup>7</sup> This result stems from the definitions of terms used in each agency's regulations. For example, the OCC's regulations require that national banks maintain total capital equal to at least 6% of "adjusted total assets" and primary capital equal to at least 5.5% of "adjusted total assets." See 12 CFR 3.6. "Adjusted total assets" is defined by reference to the average total assets figure computed for and stated in a bank's most recent quarterly Call Report. *Id.* at § 3.2(a). Assets that a national bank has not transferred, and asset transfers that are not accorded sale treatment, are included in the average total assets reported in the Call Report. Conversely, asset transfers that are given sale treatment are not reported as part of the bank's asset base, and thus are not factored into the denominator of the primary and total capital ratios.

Similarly, the FRB guidelines and the FDIC regulations for federally-insured state-chartered member and nonmember banks require these institutions to maintain minimum levels of total capital to "total assets" of 6% and of primary capital to "total assets" of 5.5%. See 12 CFR 208.13 and appendix B to 12 CFR part 225. See also 12 CFR 325.3(b). The total assets figure used in calculating these ratios is defined with reference to the quarterly average total assets figure reported on a bank's Call Report. See appendix B to 12 CFR part 225. "Capital Ratios." See also 12 CFR 325.2(k). If an asset is not reported in a federally-insured state-chartered member or nonmember bank's Call Report, the asset is not factored into the calculation of the bank's "total assets."

the Call Report establishes four distinct rules for determining whether an asset transfer with recourse will receive sale treatment, capital support is required for some recourse arrangements but not for others. In addition, the various capital charges, like the different reporting treatments, do not take into account a bank's relative exposure to risk of loss.

In recognition of off-balance sheet exposures, such as the potential risk of loss from asset transfers with recourse that are reported as sales, the FRB, the FDIC and the OCC have always reserved the right to require banks to increase their capital. However, the regulations require a bank that has limited its recourse exposure on an asset transfer with recourse which cannot be reported as a sale to maintain capital against the full amount of the asset.

The OTS currently requires each savings association to maintain a leverage ratio, which is calculated as a percentage of its adjusted total assets as reported in the "Consolidated Capital Requirement" form, filed with the TFR. For purposes of its leverage ratio, the OTS uses "tangible assets" and "adjusted tangible assets", as defined in its capital regulation. These terms do not include assets that have been reported as sold in accordance with GAAP. The OTS regulation does not refer a savings association to its reported asset base for purposes of calculating its leverage ratio.

### B. Risk-Based Capital

The risk-based capital guidelines of the FRB, the FDIC and the OCC establish a uniform definition of capital and a minimum risk-based capital ratio which is intended to enhance competitive equality among financial institutions. The guidelines specifically recognize the relative credit risk of different types of bank assets and off-balance sheet items.

Under the risk-based capital guidelines, a bank will be required to hold capital against an asset transferred with recourse even if the transfer is reported as a sale. For example, in addressing the risk-weighting of off-balance sheet exposures of national banks, the OCC's risk-based capital guidelines state that capital must be held against the full value of "assets sold under an agreement to repurchase and assets sold with recourse, to the extent that these assets are *not* reported on a national bank's statement of condition \* \* \*." Appendix A to 12 CFR part 3, section 3(b)(1)(iii) (emphasis added). The risk-based capital guidelines of the FRB and the FDIC contain similar provisions. See

<sup>8</sup> In March, 1989, the FFIEC issued reporting guidance for certain new items being added to the Call Report's Schedule RC-L, which has now been incorporated in the Call Report Instructions. See pages 7 and 8 of the enclosure to the FFIEC's Bank Letter dated March 9, 1989 (BL-10-89) and Call Report Instructions (Schedule RC-L, Instructions to Item 9(b)(1)). Among other provisions, this guidance clarified the meaning of "significant risk of loss," stating that if "the maximum contractual exposure under the recourse provision (or through the retention of a subordinated interest in the mortgages) at the time of the transfer is greater than the amount of probable loss that the bank has reasonably estimated that it will incur," then the "issuing bank" has retained the entire risk of loss, and the mortgage transfers may not be reported as sales. *Id.*

<sup>9</sup> See 12 U.S.C. 2279aa *et seq.* (establishing the Federal Agricultural Mortgage Corporation, known as "Farmer Mac").

<sup>7</sup> See *infra* section IV(B) (1) for discussion of GAAP treatment of asset sales with recourse.

Appendix A to 12 CFR part 208, Attachment IV and appendix A to 12 CFR part 325, II(D)(1).<sup>10</sup> Thus, the treatment of a recourse arrangement and the calculation of a bank's minimum risk-based capital ratio under the banking agencies' guidelines is independent of the reporting treatment of an asset transfer.

The OTS currently applies a risk-based capital standard to the recourse arrangements of savings associations. See 12 CFR Part 567. These capital standards were adopted pursuant to FIRREA, and became effective on December 7, 1989, subject to a three-year phase-in period.<sup>11</sup> Under the OTS's rules, similar to the bank supervisory agencies' risk-based capital guidelines, any capital charge associated with an asset transfer is determined independently of its reporting treatment. Generally, savings associations that transfer assets with recourse must hold the amount of capital that would be required if they had not transferred the assets. An exception is provided for transactions in which the amount of recourse retained is less than the capital that would be required to support the credit risk associated with the transferred asset. In such cases, the savings association must only maintain capital equal to the amount of the recourse.

#### *C. Proposed New Leverage Ratios for National Banks and Federally-Insured State-Chartered Banks*

The OCC and the FRB have recently proposed, and the FDIC expects to propose, new leverage ratios which, in conjunction with the risk-based capital guidelines, would replace the current leverage ratios. As with the current leverage ratios, the new leverage ratios would require a bank to maintain a minimum amount of capital calculated as a percentage of its asset base reported in the Call Report.<sup>12</sup> The FRB,

the FDIC and the OCC recognize that any revisions to the Call Report Instructions that would affect the reporting treatment of an asset transfer with recourse might also affect the calculation of the leverage ratio.<sup>13</sup>

#### **III. Current Lending Limit Treatment of Recourse Arrangements**

Banks and savings associations are subject to statutory limits on the total loans or extensions of credit that may be outstanding to a borrower at one time.<sup>14</sup> Among other purposes, the lending limit is intended to safeguard depositors by promoting credit risk diversification. Generally, for a national bank or savings association, total unsecured loans or extensions of credit outstanding to any one borrower at one time may not exceed 15% of the institution's unimpaired capital and unimpaired surplus. Amounts up to an additional 10% of unimpaired capital and surplus may be extended for loans and extensions of credit secured by readily marketable collateral.<sup>15</sup> State-chartered banks are subject to state-imposed lending limits which are also expressed as percentages of capital.

The current lending limit calculation for national banks and savings associations measures the amount outstanding to a borrower as a function of the total dollars lent plus, under some circumstances, the amount committed. With respect to loan transfers with recourse, the OCC's regulations provide that when a bank sells a whole loan or loan participation in a transaction that does not result in a pro rata sharing of credit risk between the bank and the purchaser, the total amount of the loan transferred must still be included in the lending limit calculation of the amount outstanding to the underlying borrower.<sup>16</sup> In effect, if a bank transfers a loan with recourse, the lending limit is applied to the full amount of the loan as though it has not been transferred.

The OCC's treatment of loan transfers with recourse under the lending limit is premised on the theory that when a bank transfers a loan with recourse, it

may have retained a concentration of the risk of nonpayment from the loan. For example, assume that a bank makes a \$100,000 loan. If the bank sells the loan with 10% recourse, it will have retained the risk of the first \$10,000 of loss on the entire loan. By accepting the first dollars of loss rather than agreeing to share losses with the purchaser on a pro rata basis, the bank has clearly retained a disproportionate amount of the risk in the whole loan. The current lending limit treatment of recourse arrangements prevent a bank from being able to sell a borrower's loans in order to be able to continue making new loans to that borrower, when the bank has actually retained a disproportionate exposure to that borrower's risk of default. This approach encourages risk diversification by preventing the bank from leveraging and concentrating risk in the same borrower.

#### **IV. Issues for Comment**

The Agencies consider it timely and appropriate to review the regulatory treatment of recourse arrangements, particularly in the context of the risk-based capital framework which affords an opportunity for the separate determination of reporting and capital treatments. As the risk-based capital guidelines of the FRB, the FDIC and the OCC become effective as of December 31, 1990, the Agencies are considering using the same date as the effective date for changes made to the regulatory treatment of recourse arrangements.

As set forth below, the Agencies request comment on how the term "recourse arrangement" should be defined, how such arrangements should be reported, and how the required capital support should be determined. Additionally, comment is requested on how recourse arrangements should be treated for purposes of the lending limit applicable to national banks and savings associations.

##### *A. Definition of "Recourse Arrangement"*

The Agencies are considering developing a broad definition of the term "recourse arrangement" that will recognize the potential effects of any arrangement that exposes a financial institution to a risk of loss. The Agencies request comment on how "recourse arrangement" should be defined, including how the issues discussed below should be addressed. The Agencies also request comment on the feasibility and appropriateness of developing a single definition for capital and reporting purposes, and on whether such a single definition could also be

<sup>10</sup> The explanation of this provision in each of the three agencies' guidelines refers to the Call Report to establish a definition of "asset sales with recourse," and has apparently created some interpretive confusion. The FRB, the FDIC and the OCC intend to publish technical amendments to their risk-based capital guidelines to clarify the scope of this provision.

<sup>11</sup> See FIRREA, section 301 (amending the Home Owners' Loan Act of 1933 by adding a new section 5(i), requiring OTS to establish capital standards "no less stringent than the capital standards applicable to national banks").

<sup>12</sup> See 54 FR 46394 (November 3, 1989) (OCC Notice of Proposed Rulemaking); 55 FR 582 (January 5, 1990) (FRB Notice of Proposed Rulemaking). The OCC proposal would use a national bank's "adjusted total assets" and the FRB proposal would use a state-chartered member bank or bank holding company's "total assets" as the asset base against which the new leverage ratio would be calculated.

<sup>13</sup> By contrast, because the OTS regulations do not require a savings association's leverage ratio to be calculated with reference to its reported asset base, changes in the reporting treatment of an asset transfer with recourse would not affect a savings association's leverage ratio.

<sup>14</sup> See *supra* note 2 accompanying text.

<sup>15</sup> FIRREA provides certain additional lending authority to savings associations under "Special Rule." See 12 U.S.C. 1464(u).

<sup>16</sup> See 12 CFR 32.107. See also 54 FR 43398 (October 24, 1989) (Notice of Proposed Rulemaking amending 12 CFR part 32, proposing to move the text of 12 CFR 32.107, without substantive change). See also 12 CFR 7.7519 (loan repurchase agreements).



used for purposes of the lending limit applicable to national banks and savings associations.<sup>17</sup>

### 1. Explicit Recourse

A financial institution may accept or retain recourse pursuant to an explicit and legally binding agreement in many ways. The traditional concept of "recourse" is that of the loan seller's retention of some credit risk. Today, seller assurances against loss are increasingly extended to other types of risk, including interest rate and prepayment risk, foreign exchange risk, liquidity or marketability risks, and risks associated with a borrower's regulatory noncompliance or uninsurable hazards.

The Agencies recognize that asset sales are typically accompanied by certain standard representations and warranties concerning items within the seller's control. For example, the seller may warrant that a loan is not delinquent or is in compliance with consumer protection laws as of the date of the sale. If the triggering event is within the seller's control, the selling institution may be able to adequately protect itself, and it may be inappropriate to regulate the arrangement as a recourse arrangement. The Agencies therefore request comment on what types of standard representations and warranties should be excluded from regulatory treatment as recourse arrangements.

The Agencies are concerned, however, that some financial institutions have also offered unusual warranties and representations in situations that they cannot control. For example, some financial institutions have assumed risks associated with a borrower's failure to maintain loan collateral in compliance with environmental or health and safety laws, or have agreed to substitute loans in the event of prepayment. The Agencies request comment on the extent to which the definition of "recourse arrangement" should include exposure to risks other than credit risk.

The Agencies also recognize that in applying the risk-based capital standards and possibly for other regulatory purposes, it may be

appropriate to treat certain limited recourse arrangements differently than full recourse arrangements. The Agencies request comment on the methods available to financial institutions for providing limited recourse and on how to identify those limited recourse arrangements for which separate regulatory treatment might be appropriate.

In addition to recourse arrangements that may arise from a financial institution's sale of its own assets, a financial institution may also provide explicit assurances against the risk of loss associated with a third party's assets. For example, as the servicer of a pool of assets, a financial institution may accept some exposure to credit risk from the pool. As part of a brokering agreement, an institution may provide credit enhancement to ensure the performance of an issue, designed to absorb loss to the extent of the enhancement, or may commit to certain market-making activities. The Agencies request comment on how risks that do not arise from a financial institution's ownership or prior ownership of assets should be addressed in the definition of "recourse arrangement."

### 2. Implicit Recourse

A financial institution may also effectively assume recourse without an explicit contractual agreement. Implicit recourse is usually demonstrated by an institution's action subsequent to the sale of an asset. Implicit recourse may arise as a result of a loan seller's desire for a continuing relationship with a borrower, or for protection of its reputation with investors. For example, having packaged and sold a portfolio of loans without recourse, a financial institution may elect to rewrite the defaulted loan of a valued borrower that the institution believes is having temporary difficulties in repayment. A financial institution may also be tempted to repurchase assets it has sold into a pool that are not performing well, in order to protect the institution's reputation with investors and the public generally. The Agencies request comment on how the definition of "recourse arrangement" should address implicit recourse.

### 3. Methods of Providing Recourse

Assurances against loss may be provided through a variety of means. In some cases, recourse is provided through recourse clauses in sales contracts or put options granted in connection with asset sales. Recourse may also be provided through transactions that involve the creation of separate financial products.

For example, subordinated securities issued when loans are pooled and senior and subordinated classes of securities are created can operate analogously to recourse provisions on individual loans. The subordinated securities protect the senior securities by being first in line to absorb losses on the pool. Similarly, a second mortgage might function as a recourse arrangement. If a financial institution originates first and second mortgages on the same property and sells the first mortgage but retains the second mortgage, the financial institution is first in line to absorb losses in the event of the borrower's default. Claims under the second mortgage will only be met after the holder's claims under the first mortgage are satisfied.

A letter of credit intended to absorb losses on an asset or pool of assets originated or pooled by a third party may also effectively constitute recourse. If the third party seller is not obligated to reimburse the institution providing the letter of credit for any payments made under the letter of credit, then the letter of credit institution will have assumed a risk of loss on the assets. Alternatively, if the third party seller must reimburse the letter of credit institution, then that third party seller has effectively retained recourse on the assets sold equal to the amount of the letter of credit. In addition, the letter of credit institution would be exposed to a risk of loss on the assets in the event that the third party should fail to reimburse as required by the contract.<sup>18</sup>

The Agencies request comment on methods available to a financial institution to accept, assume or retain recourse. For example, as discussed herein, the Agencies request comment on whether subordinated securities, second mortgages or letter of credit enhancements should be treated as recourse arrangements, both where these interests are retained or acquired by the seller and where they are purchased or provided by a third party financial institution. With respect to subordinated securities, the Agencies specifically request comment on how

<sup>17</sup> As indicated *infra* at note 28, the application of the lending limit to recourse arrangements is being considered only insofar as these arrangements expose a bank or savings association to credit risk. Thus, to the extent that the definition of recourse arrangement developed for use in the capital or regulatory reporting context includes arrangements that expose institutions to risks other than credit risk, the same definition would not be appropriate for use in the lending limit context. To the extent that the definition covers arrangements that expose an institution on credit risk, comment is requested on whether those same arrangements should be considered recourse for lending limit purposes.

<sup>18</sup> Although letter of credit enhancements may ultimately be found to be "recourse arrangements" for regulatory reporting, capital or lending limit considerations, the OCC does not construe such letters of credit to create "recourse" in connection with sales of credit-enhanced securities for the purposes of section 16 of the Glass-Steagall Act. See 12 U.S.C. 24 (Seventh). This section authorizes national banks to sell "securities and stock without recourse" for their customers. See, e.g., *Securities Industry Association v. Comptroller of the Currency*, 577 F. Supp. 252 (D.D.C. 1983); *Awotin v. Atlas Exchange National Bank*, 295 U.S. 208 (1935); and OCC Interpretive Letter No. 212, reprinted in [1981-82 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,293 (July 2, 1981).

the definition of recourse should treat the middle classes, *i.e.*, the higher tier subordinated pieces, of issues that have more than two classes of securities.

#### *B. Reporting Treatment of Asset Transfers With Recourse*

As already discussed, the current Call Report treatment of an asset transfer with recourse for national and federally-insured, state-chartered banks varies, depending upon a range of factors. The Call Report requirements differ from the GAAP reporting requirements, which are generally applicable to savings associations. The FRB, the FDIC and the OCC believe that the present Call Report Instructions for asset transfers with recourse should be reevaluated. These agencies intend to work through the FFIEC in order to amend the Call Report requirements, as necessary. See 12 U.S.C. 3305(a).

The FRB, the FDIC and the OCC request comment on how assets transferred with recourse should be reported, including (1) Whether these agencies should consider adopting the GAAP approach for asset transfers with recourse, either in part or in its entirety, or some other wholly consistent approach, and (2) how changes to regulatory reporting will or should affect these agencies' leverage ratios.

#### 1. Possible Adoption of GAAP Reporting Treatment of Asset Transfers with Recourse by the FRB, the FDIC, and the OCC

The GAAP definition of "sale" for transfers of receivables with recourse is discussed in the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 77 ("FAS 77").<sup>19</sup> According to FAS 77, a transfer of receivables with recourse is to be reported as a sale if the reporting entity meets three conditions: (1) The transferor must surrender control of the future economic benefits embodied in the asset; (2) the transferor must be able to reasonably estimate its obligations under the recourse provision; and (3) the transferor must not be obligated to repurchase the assets except pursuant to the recourse provisions.

FAS 77 further provides: "If a transfer qualifies to be recognized as a sale, all probable adjustments in connection

<sup>19</sup> See Statement of Financial Accounting Standards No. 77, "Reporting by Transferors for Transfers of Receivables with Recourse" (December, 1983). For the purpose of FAS 77 "recourse" is defined as the "right of a transferee of receivables to receive payment from the transferor of those receivables for (a) Failure of the debtors to pay when due, (b) the effects of prepayments, or (c) adjustments resulting from defects in the eligibility of the transferred receivables." See appendix A, FAS 77.

with the recourse obligations to the transferor shall be accrued in accordance with FASB Statement No. 5, 'Accounting for Contingencies' ['FAS 5']." FAS 5 requires the transferor of an asset with recourse to accrue by a charge to income an amount sufficient to absorb the transferor's estimated obligations under the recourse provision. The recourse obligation must be accrued as a liability or specific reserve,<sup>20</sup> and may not be included as part of the general allowance for loan and lease losses.<sup>21</sup>

After the Financial Accounting Standards Board adopted FAS 77, the FRB, the FDIC and the OCC, as members of the FFIEC, considered incorporating this accounting standard into their regulatory reporting requirements for assets transferred with recourse. At that time, the FFIEC chose not to follow FAS 77, concluding that it emphasized the transfer of future economic benefits, whereas the agencies were most concerned with a financial institution's retention of a risk of loss. The FFIEC also expressed concern that it might be difficult to reasonably estimate the risk of loss on some assets, such as commercial, construction and international loans.<sup>22</sup>

Although the FRB, the FDIC and the OCC have previously rejected the FAS 77 reporting treatment for most asset transfers with recourse, these agencies are also committed to an ongoing effort to minimize the differences between generally accepted accounting principles and regulatory reporting requirements where possible. For example, one possibility is that the agencies might adopt the GAAP approach for some types of assets, such as loans considered subject to reasonable estimations of loss, but not necessarily for all types of assets.

In addition, the FRB, the FDIC and the OCC note that once their risk-based capital guidelines are implemented, the adoption of the GAAP reporting approach would not affect bank capital ratios to the same extent it would have

<sup>20</sup> See Statement of Financial Accounting Standards No. 105, "Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk," (March, 1990), paragraph 92, which states "[t]he [Financial Accounting Standards] Board believes that generally accepted accounting principles proscribe inclusion of an accrual for credit loss on a financial instrument with off-balance-sheet risk in a valuation account (allowance for loan losses) related to a recognized financial instrument."

<sup>21</sup> Because accrued recourse obligations are specifically identifiable to the sold assets, they are not included in capital.

<sup>22</sup> See October 28, 1985 FFIEC letter to Chief Executive Officers of Banks (Appendix).

when the FFIEC originally considered FAS 77 in 1985. The requirement of capital support for an asset transfer at that time depended solely upon its reporting treatment. As discussed above, under the risk-based capital standards, national and federally-insured, state-chartered banks will be required to hold capital against an asset transferred with recourse even when the transfer is reported as a sale.

#### 2. Possible Impact on the FRB, FDIC, and OCC Leverage Ratios

If the FRB, the FDIC and the OCC adopt the FAS 77 approach for reporting asset transfers with recourse, some asset transfers not currently reported as sales for Call Report purposes would qualify for sale treatment. If some other reporting treatment is adopted, it is also possible that some asset transfers currently reported as sales in the Call Report might no longer qualify for sale treatment. Either of these outcomes would potentially affect the capital required to meet the leverage ratios. Removing assets from the Call Report balance sheet would have the effect of lowering the reported asset base against which capital must be held for leverage purposes, thereby lowering the amount of capital required to meet the leverage ratios. Retaining additional assets on the balance sheet would have the effect of increasing the reported asset base, thereby increasing the capital necessary to meet the leverage ratios. The Agencies request comment on whether the leverage ratio calculation should be adjusted to include assets removed from the balance sheet and/or to exclude assets added to the balance sheet as a result of changes in the regulatory reporting treatment of recourse arrangements.

#### C. Capital Support Required for a Recourse Arrangement

##### 1. Explicit Recourse Arrangements

The Agencies are considering requiring a financial institution that enters into an explicit, contractually binding, recourse arrangement to quantify its maximum possible risk of loss and to hold capital commensurate with that risk. This approach is consistent with the direction taken for asset transfers with recourse in establishing the risk-based capital standards. Nonetheless, the Agencies recognize the possible utility of some adjustments in the application of their risk-based capital standards, as presently drafted, to asset transfers with recourse.

The Agencies request comment on the general approach that they are



considering for capital charges against explicit recourse arrangements. As discussed below, the Agencies specifically request comment on the feasibility and appropriateness of (a) Applying consistent capital charges to similar recourse exposures that arise as a result of a financial institution's prior ownership of an asset; (b) requiring equivalent capital charges for comparable recourse exposures that do not arise as a result of the financial institution's prior ownership of an asset; and (c) tailoring the capital charges to the relative exposure of particular recourse arrangements. The Agencies request that commenters give particular focus to ways of addressing limited recourse arrangements. In addition, the Agencies request that commenters address how insured financial institutions and bank holding companies' need for adequate capital should be balanced against their need to compete in markets that include participants subject to less stringent capital standards.

*(a) Consistent Capital Charges for Recourse on Previously Owned Assets.* The risk-based capital standards do not necessarily apply the same capital treatment to differently structured asset transfers that have the same potential effect on an institution's earnings, assets or capital.

For example, the risk-based capital standards require different capital support for a mortgage transferred with recourse and a second mortgage, which may be used in place of a recourse clause. To illustrate, if a financial institution originates a \$100,000 qualifying, first lien residential mortgage, it will be required to hold \$4000 in capital support against the loan ( $\$100,000 \times 50\% \text{ risk-weight} \times 8\%$ ). If the originating institution sells this mortgage loan subject to a 10% recourse provision, the capital charge will not change. Alternatively, the same institution might originate two separate mortgages, a first mortgage for \$90,000 and a second mortgage for \$10,000. If the institution sells the first mortgage without recourse but retains the second mortgage, there will be no capital charge against the first mortgage and the charge against the second mortgage will only be \$800 ( $\$10,000 \times 100\% \times 8\%$ ). Because the financial institution will absorb the first \$10,000 of losses under either of these arrangements, the maximum possible risk of loss on the two transactions is the same.

As another example of inconsistent capital treatments for asset transfers, the risk-based capital standards treat a seller's retained residual interest in a

pool of assets differently than subordinated interests or other forms retained recourse. In general terms, a residual interest in an interest in any excess cash flow stemming from a securitized asset pool over and above the amounts required to pay investors and applicable administrative expenses. Residual interests, like subordinated interests or other recourse arrangements, may absorb more than their pro rata share of loss. However, in certain cases, a financial institution that sells assets and retains a residual interest in them need hold capital only against that interest. By contrast, if the institution sells assets and retains subordinated securities or other forms of recourse it must hold capital against the entire amount of the assets sold.

*(b) Equivalent Capital Charges for Recourse on Third Party Assets.* The risk-based capital guidelines of the bank supervisory agencies do not explicitly address recourse arrangements that do not arise as a result of a financial institution's prior ownership of an asset. For example, mortgage servicing rights that a financial institution purchases from another party may include various types of recourse, including the requirement that the purchasing institution absorb credit losses on the loans it has agreed to service. It is important that the risks associated with these transactions be understood, quantified and risk-weighted as with any other off-balance sheet credit exposure. The OTS capital rule currently requires savings associations with mortgage servicing rights that include exposure to credit losses to hold capital against the full amount of the underlying loans through the application of the 100% credit conversion factor.

As another example, the risk-based capital guidelines of the bank supervisory agencies treat subordinated interests differently depending upon whether the bank retains a subordinated interest in assets it has owned and transferred, or purchases a subordinated interest in third party assets. The FRB, the FDIC, the OCC and the OTS all require financial institutions retaining the subordinated portion of a senior/subordinated structure to hold capital against the full amount of the assets transferred. However, if a bank purchases subordinated securities representing interests in loans that it has not originated or owned, the FRB, the FDIC and the OCC place only the purchased subordinated securities in a 100% risk-weight category. No capital is required for the senior portions supported by the purchased

subordinated portions.<sup>23</sup> By contrast, the OTS treats purchased subordinated securities the same as originated subordinated securities, and thus requires savings associations to hold capital against the whole asset pool.

*(c) Capital Charges Tailored to Relative Risks.* The risk-based capital standards do not necessarily require capital support commensurate with the relative risk exposure of a particular recourse arrangement.

For example, the risk-based capital guidelines of the bank supervisory agencies, as opposed to those of the OTS, do not distinguish between limited and unlimited recourse arrangements. The bank supervisory agencies require capital to be held against the full amount of an asset transferred with recourse, even if the transferring bank has limited its risk of loss on the recourse provision. The risk-based capital rules of the OTS differ in that they generally permit a savings association to maintain capital equal to the amount of the recourse exposure on an asset transferred with recourse if that exposure is less than the capital charge the asset would otherwise incur.

The Agencies believe that failing to give capital credit for any form of limited recourse may actually create an incentive for financial institutions to maximize their risk of loss in transferring assets with recourse. This is because buyers may pay more for assets sold with greater recourse than for the same assets sold with less recourse. If there are no additional capital charges for sales with full recourse, financial institutions may decide to transfer assets with full rather than limited recourse in order to benefit from higher sale prices.

The risk-based capital guidelines of the bank supervisory agencies also do not permit a reduction in the capital charge when a bank establishes a recourse liability account for its estimated obligations under the recourse provision. Similarly, the risk-based capital standards of the bank supervisory agencies and OTS may not fully address the interaction of third party guarantees or insurance that may be obtained by insured financial institutions to reduce their potential losses on assets they transfer with recourse.

<sup>23</sup> This discussion of the "purchase" of a subordinated security is undertaken solely as an illustration, and should not be viewed as an indication that such securities would be eligible for bank investment under federal or state law, or that bank holdings of such securities would not be subject to examiner criticisms or classifications.



For example, assume that a bank transfers by means of a privately-issued certificate of participation a \$1,000,000 pool of qualifying, first lien residential mortgage loans subject to 10% recourse in a transaction that may be treated as a sale for Call Report purposes.<sup>24</sup> Estimating its probable losses on the loans to be only 3%, the bank establishes a recourse liability account for \$30,000. Under the risk-based capital guidelines of the bank supervisory agencies, however, the creation of the recourse liability account would not operate to reduce the amount of the loans for determining the capital charge. Thus, notwithstanding the \$30,000 recourse liability account, the bank would still be required to maintain capital against the full amount of the loans, or capital of \$40,000 ( $\$1,000,000 \times 50\% \text{ risk-weight} \times 8\%$ ). This treatment may actually discourage a bank from establishing an adequate recourse liability account.

By contrast, under the risk-based capital rules of the OTS, a savings association transferring the same pool of loans and establishing the same liability account may net the account against the full amount of the loans transferred. Thus, the total amount of the loans outstanding for capital purposes would be reduced to \$970,000, and the net recourse exposure would drop from \$100,000 to \$70,000. Because the liability account is netted against the total outstanding amount of the loans rather than the capital requirement, the savings association would be required to hold capital of \$38,800 ( $\$970,000 \times 50\% \text{ risk-weight} \times 8\%$ ). If the recourse liability account had reduced the net recourse exposure below the capital requirement for the full amount of the loans less the recourse liability account, then the capital charge would have been reduced to the level of the net recourse exposure. For example, if the association had established a recourse liability account of \$80,000, then the required capital would have been limited to the amount of the net recourse exposure of \$20,000.

The risk-based capital standards also do not necessarily recognize differences in the degree to which an asset transferred with recourse is collateralized.<sup>25</sup> For example, assume

that a savings association originated two \$100,000 mortgage loans, one with a loan-to-collateral value ratio of 50%, and the other with a loan-to-collateral value ratio of 75%. If the savings association subsequently transferred both loans, each with 10% recourse, it would be required to hold the same minimum capital against each loan, despite the differences in the underlying collateral values.

Another example of a collateralized recourse arrangement involves the lending of customers' securities. Financial institutions that lend their customers' securities to third parties may provide protection against loss to the customers. The degree of such protection may vary from total indemnification to simply a guarantee that the customer will not lose money as a result of a decline in the market value of the pledged collateral should the borrower fail to return the securities. Thus, when a financial institution lends its customer's securities the degree of risk retained can vary from a very low percentage of 100% of the value of the lent securities. Nevertheless, if the financial institution provides any loss protection to the customer, the risk-based capital standards require that capital be held for the entire amount of the securities lent regardless of the level of the guarantee that is provided.

The risk-based capital standards also do not distinguish between recourse arrangements with different probabilities of loss. Thus, if a savings association or bank transfers ten loans, each with a balance of \$100,000, subject to 10% recourse per loan, or transfers the same loans with 10% recourse on the pool, the bank's total potential liability in each case is \$100,000 (10 loans  $\times$  \$100,000  $\times$  10%). The total capital required in each case would be \$80,000 (10 loans  $\times$  \$100,000  $\times$  8%). Nonetheless, the probability of loss in the latter instance is greater. If the recourse is on a "per loan" basis, the institution cannot lose the full \$100,000 unless each of the ten loans loses \$10,000. By contrast, if the recourse is on a "pool" basis, various combinations of loss, e.g., one loan losing \$100,000, or two loans each losing \$50,000, may result in the institution's absorbing its total potential loss.

Finally, the risk-based capital standards do not necessarily distinguish between recourse arrangements

structured as second dollars of loss and recourse arrangements structured as first dollars of loss. For example, in certain recourse arrangements, a financial institution undertakes to cover losses only after another party has already absorbed some loss. Even though the actual risk of loss is less than if the financial institution were obligated to absorb the first dollars of loss, the risk-based capital standards may require identical treatment of these recourse arrangements, depending on the particular factual situation.

## 2. Implicit Recourse Arrangements

The Agencies believe that financial institutions should not assume implicit recourse unless capital support is provided. The Agencies also recognize that the exposure arising from an implicit recourse arrangement, as opposed to an explicit arrangement, is difficult to quantify, and that it may not be feasible to apply the risk-based capital ratios to implicit arrangements. Accordingly, the Agencies will consider whether alternative approaches should be employed to control financial institutions' use of implicit recourse arrangements.

The Agencies note that existing regulatory constraints may already afford financial institutions some protection against the risks of assuming implicit recourse. For example, the requirement that a financial institution maintain specified capital ratios may limit the degree to which an institution can actually reacquire assets as a result of assuming implicit recourse. Prior to purchasing a poorly performing asset from a pool, the institution ordinarily must determine that it has adequate excess capital to book the asset. In addition, the desire for a particular tax treatment of a trust or single-purpose entity created to issue asset-backed securities may restrict a financial institution's ability to repurchase or exchange poorly performing assets.

The Agencies believe that implicit recourse arrangements are frequently associated with asset transfers, and especially securitized asset sales in which the issuing or selling institution may seek to ensure the issue's performance. To address this problem, the Agencies are considering requiring issuing and selling institutions to provide disclosures to purchasers that disclaim any financial institution's obligation for the performance of the transferred assets (other than obligations that may be explicitly assumed).

In addition, as has been their past practice, the Agencies will seek to

<sup>24</sup> Under the current Call Report Instructions, such a transaction would not receive sale treatment because the bank would retain more than a "significant risk of loss" on the loans transferred. However, if the FFIEC were to adopt the GAAP approach for reporting asset transfers with recourse, the issues raised in this example would arise.

<sup>25</sup> This situation is not unique to assets transferred with recourse, but also applies to on-balance sheet assets that are collateralized (other than by so-called "qualifying collateral"). The risk-

based capital ratio focuses principally on broad categories of credit risk. The ratio does not take account of many other factors that can affect an institution's financial condition such as the quality of individual loans and investments and the degree to which they are protected by collateral.

identify implicit recourse arrangements in the course of their examination and supervision of individual institutions.

If the primary federal supervisory agency for an individual financial institution determines that the institution habitually or consistently repurchases or rewrites assets it has sold that subsequently perform poorly, that agency will require that institution to maintain additional capital. The institution may also be required to treat the outstanding amount of other similar assets sold as though transferred with recourse for regulatory reporting purposes. A repetitive pattern of renewals or rewrites may also be determined to be an unsafe and unsound banking practice.<sup>26</sup>

The Agencies request comment on their consideration of a disclosure requirement as one approach to discouraging financial institutions from assuming implicit recourse in connection with securitized asset sales and other asset transfers. The Agencies also request comment on any methods that may be used to estimate exposure arising from implicit recourse arrangements and on any other ways of addressing implicit recourse arrangements. Finally, the Agencies request comment on how the risk-based capital standards should be applied once it is determined that an institution clearly has assumed implicit recourse in a transaction or series of transactions.

#### *D. Lending Limit Treatment of Recourse Arrangements*

As discussed above, the lending limit calculation generally requires a national bank or savings association that transfers a loan with recourse to include the full amount of that loan in calculating the total loans and extensions of credit outstanding to the underlying borrower. The OCC and the OTS recognize, however, that other methods of computing the lending limit may be appropriate when an institution transfers a loan with partial recourse or otherwise limits its credit risk exposure from a recourse arrangement.<sup>27</sup> The

<sup>26</sup> The Agencies emphasize that they do not intend to discourage a financial institution with adequate capital from independently deciding to repurchase or rewrite a sold loan that is performing poorly, when the institution intends to work with the underlying borrower and the accommodation is clearly in the best interests of the institution and the borrower.

<sup>27</sup> Some states apply the lending limit for national banks to state-chartered banks. Therefore, changes in the OCC's lending limit treatment of recourse arrangements could affect some state-chartered banks as well as national banks and savings associations.

OCC and the OTS also recognize some inconsistencies in the current application of the lending limit to recourse arrangements. As for federally-insured, state-chartered banks, the staffs of the FRB and the FDIC believe that recourse exposure should be combined in some manner with all loans to one borrower for purposes of applying legal lending limits under state laws.<sup>28</sup>

Comment is requested on how the lending limit calculation for national banks and savings associations should treat recourse arrangements generally, including the questions listed below. Comment is also requested on how lending limit calculations for federally-insured, state-chartered banks should treat such arrangements, including the questions listed below. Comment is also solicited on whether and how to achieve a more uniform treatment of recourse arrangements in lending limit calculations under the various applicable state laws.

1. If an institution transfers a loan with partial recourse, would it be appropriate to include less than the full outstanding amount of the loan transferred in the calculation of loans and extensions of credit outstanding to the borrower? More specifically, should the lending limit recognize that while the institution may have retained a disproportionate amount of the risk of loss in the loan, it has nonetheless shifted the risk of catastrophic loss by reducing its exposure from the full amount of the loan to the amount of the recourse provision? Also, should the current treatment for national banks and savings associations be revised to permit an institution which establishes a recourse liability account covering all or part of its recourse exposure to deduct the amount of the account from the calculation of loans outstanding to the borrower? Should the establishment of such a liability account affect the calculation of loans outstanding to one borrower at federally-insured, state-chartered banks?

2. Is it appropriate to require the full outstanding balance of a loan transferred with recourse to be included in the calculation of loans outstanding to the borrower if banks and savings associations must also support the retained risk by holding capital against the full outstanding balance of the asset? This question should be

<sup>28</sup> This discussion of the lending limit treatment of recourse arrangements is intended to apply only to arrangements that expose a bank or savings association to the credit risk of a borrower. It is not intended that the lending limit would apply to recourse arrangements that expose an institution to other types of risk.

considered in view of the fact that capital requirements are specifically intended to address the risk contained in an institution's assets and off-balance sheet items, whereas the lending limit is designed to promote credit risk diversification.

3. Should the lending limit be applied to achieve a more consistent treatment of different types of transactions that may expose an institution to the same degree of credit risk from an underlying borrower? For example, for national banks and savings associations, there is a discrepancy between the lending limit treatment accorded subordinated loans and the treatment accorded subordinated participations. If an institution originates first and second mortgages, on the same property and sells only the first mortgage, the second mortgage will function as a recourse arrangement on the first mortgage. Yet, the institution is required to include only the amount of the second mortgage in its calculation of loans outstanding to the borrower. By contrast, if the institution made a single loan to the same borrower for the same total amount, and then sold the loan with recourse equal to the amount of the second mortgage, the entire loan would be included in the lending limit calculation. Arguably, despite the differing lending limit treatments, the institution's exposure to the borrower's credit risk in the two transactions is the same.

#### *V. Listing of Questions for Comment*

To briefly summarize, the Agencies request comment on the following issues:

The definition of "recourse arrangement":

1. How should "recourse arrangement" be defined? What types of risk should be construed as creating a recourse arrangement? Should the same definition be developed for use in the capital, reporting and, as appropriate, lending limit contexts?

2. What methods are available to a financial institution to accept, assume or retain recourse? For example, should the following items, in some circumstances, be considered "recourse arrangements": (a) Subordinated interests; (b) second mortgages; and (c) letter of credit enhancements?

The regulatory reporting treatment of a "recourse arrangement":

3. Should the FRB, the FDIC and the OCC adopt generally accepted accounting principles, in whole or in part, or adopt some other wholly consistent approach for the reporting treatment of asset transfers with recourse?

4. What effect would a change to the reporting treatment have on the leverage ratios of the FRB, the FDIC and the OCC? Should the reporting treatment of assets transferred with recourse have an effect on the leverage ratio?

The appropriate capital requirement for explicit recourse arrangements:

5. Should the Agencies impose the same capital requirement on transactions structured differently but with the same potential effect on a financial institution's income, assets or capital?

6. Should the risk-based capital standards distinguish between limited and unlimited recourse arrangements?

7. Should the risk-based capital standards take into account an established recourse liability account or third party guarantees or insurance? If so, how?

8. Should application of the risk-based capital standards to recourse arrangements take into account differences in the degree to which an asset transferred with recourse is collateralized?

9. Should the risk-based capital standards fully recognize recourse arrangements that do not arise as a result of a financial institution's prior ownership of an asset?

10. What other types of explicit recourse arrangements not discussed in this solicitation are available to financial institutions?

11. Should the risk-based capital standards distinguish between recourse arrangements with different probabilities of loss?

12. How should the need for insured depository institutions and bank holding companies to maintain adequate capital be balanced against their need to compete in markets that include participants that are subject to less stringent capital standards?

The appropriate treatment of implicit recourse arrangements:

13. Should the Agencies adopt disclosure requirements to discourage implicit recourse arrangements?

14. Are there methods available to estimate potential exposure from implicit recourse arrangements?

15. Are there ways, other than disclosure requirements, to address and discourage implicit recourse?

16. How should the risk-based capital standards be applied to a financial institution that has clearly assumed implicit recourse in a transaction or series of transactions?

Comment is requested on the following issues concerning the lending limit applicable to banks and savings associations:

17. When a bank or savings associations transfers a loan with limited recourse, should the lending limit be applied to the full amount of the assets, as though it had not been transferred?

18. Should the lending limit calculation result in the same treatment for transactions structured differently, but with the same potential risk of loss on nonpayment?

19. Is it appropriate to include the full outstanding balance of a loan transferred with recourse in the calculation of loans outstanding to the borrower when banks and savings associations are also required to hold capital against the full amount of the asset?

20. Should the treatment of recourse arrangements in legal lending limit calculations applicable to federally-insured, state-chartered banks under state laws be made more uniform? If so, how?

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**Robert J. Lawrence,**  
*Executive Secretary, Federal Financial  
Institutions Examination Council.*

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