FEDERAL RESERVE BANK
OF DALLAS

ROBERT D. McTEER, JR.
PRESIDENT
AND CHIEF EXECUTIVE OFFICER

DALLAS, TEXAS
75265-5906

June 10, 1994

Notice 94-55

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

SUBJECT

Request for Public Comment on Joint Interagency Proposal of Advanced Rulemaking Concerning the Regulatory Treatment of Recourse Arrangements and Direct Credit Substitutes

DETAILS

The Board of Governors of the Federal Reserve System is requesting public comment on an interagency proposal of advanced rulemaking concerning the regulatory treatment of recourse arrangements and direct credit substitutes.

The proposal would formally define recourse and direct credit substitutes and would base a financial institution's risk-based capital charge on its relative risk of loss in certain asset securitizations.

The Board must receive comments by July 25, 1994. Comments should be addressed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551. All comments should refer to Docket No. R-0835 and will be shared among all the agencies.

ATTACHMENT

A copy of the Board's notice as it appears on pages 27116-41, Vol. 59, No. 100, of the Federal Register dated May 25, 1994, is attached.

MORE INFORMATION

For more information, please contact Dorsey Davis at (214) 922-6051. For additional copies of this Bank's notice, please contact the Public Affairs Department at (214) 922-5254.

Sincerely yours,

Robert D. McTeer, Jr.

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Part 3

[DOCKET No. 94–07]

RIN 1557–AA91

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225

[Docket No. R–0835]

RIN 7100–AB77

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 325

RIN 3064–AB31

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

12 CFR Part 567

[Docket No. 93–238]

RIN 1550–AA70

Risk-Based Capital Requirements—Recourse and Direct Credit Substitutes

AGENCIES: Office of the Comptroller of the Currency (OCC), Department of the Treasury; Board of Governors of the Federal Reserve System (FRB); Federal Deposit Insurance Corporation (FDIC); Office of Thrift Supervision (OTS), Department of the Treasury.

ACTION: Notice of proposed rulemaking and advance notice of proposed rulemaking.

SUMMARY: The FDIC, FRB, OCC, and OTS (the Agencies) are proposing revisions to their risk-based capital standards to address the regulatory capital treatment of recourse arrangements and direct credit substitutes that expose banks, bank holding companies, and thrifts to credit risk. The proposal is intended to correct certain inconsistencies in the Agencies' risk-based capital standards and allow banks and bank holding companies (banking organizations) to maintain lower amounts of capital against low-level recourse transactions. The proposal would require higher amounts of risk-based capital to be maintained against certain direct credit substitutes, including, for banking organizations, purchased servicing rights that provide loss protection to the owners of the loans serviced and purchased subordinated interests that absorb the first dollars of losses from the underlying assets, and, for both banking organizations and thrifts, certain guarantee-type arrangements (such as standby letters of credit) provided for third-party assets that absorb the first dollars of losses from those assets.

The OTS is proposing to change only the capital requirements for the treatment of guarantee-type arrangements that absorb first dollar losses. In all other respects, the OTS treatment of recourse and direct credit substitutes would continue to follow existing OTS capital regulations. The OTS regulations have been revised for clarity and now include language codifying agency regulatory guidance.

In addition, the Agencies are publishing, in an advance notice of proposed rulemaking (ANPR), a preliminary proposal to use credit ratings to match the risk-based capital assessment more closely to an institution's relative risk of loss in certain asset securitizations. The Agencies are also requesting comment in the ANPR on the need for a similar system for unrated asset securitizations and on how such a system could be designed.

The Agencies intend that any final rules adopted in connection with this notice of proposed rulemaking and ANPR that result in increased risk-based capital requirements for banking organizations or thrifts would apply only to transactions that are consummated after the effective date of such final rules.

DATES: Comments must be received on or before July 25, 1994.

ADDRESSES: Commenters may respond to any or all of the Agencies. All comments will be shared among all of the Agencies.

OCC: Written comments should be submitted to Docket No. 94–07, Communications Division, Ninth Floor, Office of the Comptroller of the Currency, 250 E Street SW., Washington, DC 20219, Attention: Karen Carter. Comments will be available for inspection and photocopying at that address.

FRB: Comments, which should refer to Docket No. R–0835, may be mailed to the Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue NW., Washington, DC 20551, to the attention of Mr. William Wiles, Secretary. Comments addressed to the attention of Mr. Wiles may be delivered to the FRB's mail room between 8:45 a.m. and 5:15 p.m., and to the security control room outside of those hours. Both the mail room and the security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street NW. Comments may be inspected in room B–1122 between 9 a.m. and 5 p.m. weekdays, except as provided in § 261.8 of the FRB's Rules Regarding Availability of Information, 12 CFR 261.8.

FDIC: Comments should be addressed to Robert E. Feldman, Acting Executive Secretary, Federal Deposit Insurance Corporation, 550 17th Street NW., Washington, DC 20429. Comments may also be hand-delivered to Room F–400, 1776 F Street NW., between the hours of 8:30 a.m. and 5 p.m. on business days. They may be sent by facsimile transmission to FAX Number (202) 898–3838]. Comments will be available for inspection and photocopying in the FDIC's Reading Room, room 7118, 550 17th Street NW., between 9 a.m. and 4:30 p.m. on business days.

OTS: Send comments to Director, Information Services Division, Public Affairs, Office of Thrift Supervision, 1700 G Street NW., Washington, DC 20552, Attention Docket No. [93–238]. These submissions may be hand-delivered to 1700 G Street NW., between 9 a.m. and 5 p.m. on business days; they may be sent by facsimile transmission to FAX Number (202) 906–7755. Submissions must be received by 5 p.m. on the day they are due in order to be considered by the OTS. Late-filed, misaddressed or misidentified submissions will not be considered in this rulemaking. Comments will be available for inspection at 1700 G Street NW., from 1 p.m. until 4 p.m. on business days. Visitors will be escorted to and from the Public Reading Room at established intervals.

FOR FURTHER INFORMATION CONTACT:

OCC: Owen Carney, Senior Advisor for Investment Securities, Office of the Chief National Bank Examiner (202/874–5070); David Thede, Senior Attorney, Bank Operations and Assets Division (202/874–4460); Christopher Beshouri, Financial Economist, Economics and Evaluation (202/874–5220); Elizabeth Milor, Financial Economist, Regulatory and Statistical Analysis (202/874–5240).

FRB: Rhoger H. Pugh, Assistant Director (202/728–5883); Thomas R. Boemio, Supervisory Financial Analyst (202/452–2982); or David A. Elkes, Financial Analyst (202/452–5218), Division of Banking Supervision and Regulation. Telecommunication Device for the Deaf (TDD), Dorothea Thompson (202/452–3544), Board of Governors of the Federal Reserve System, 20th and C Streets NW., Washington, DC 20551.

FDIC: Robert F. Storch, Chief, Accounting Section, Division of

Supervision, (202/898–8906), or Cristeena G. Naser, Attorney, Legal Division (202/898–3587).

OTS: John F. Connolly, Senior Program Manager for Capital Policy (202/906–6465); Fred Phillips-Patrick, Senior Financial Economist (202/906–7295); Robert Kazdin, Senior Project Manager (202/906–5759), Policy; Karen Osterloh, Counsel, Banking and Finance (202/906–6639); Deborah Dakin, Assistant Chief Counsel, Regulations and Legislation Division (202/906–6445), Office of Thrift Supervision, 1700 G Street NW., Washington, DC 20552.

SUPPLEMENTARY INFORMATION:

I. Introduction and Background

A. Overview

Each of the Agencies is proposing to amend its risk-based capital standards to clarify and revise the treatment of recourse arrangements and certain direct credit substitutes that expose banking organizations (banks and bank holding companies) and thrifts to credit risk. The Banking Agencies (OCC, FRB, and FDIC) are also proposing to recommend that the FFIEC make conforming revisions to the regulatory reporting requirements applicable to asset transfers with recourse and direct credit substitutes for insured commercial banks and FDIC-supervised savings banks.

This notice of proposed rulemaking would amend the Agencies' risk-based capital standards to:

- Define the term "recourse" and expand the definition of the term "direct credit substitute";[1]
- Create an exception to the Banking Agencies' current guidelines that would reduce the amount of capital required for certain low-level recourse transactions;[2]
- Require banking organizations that purchase loan servicing rights that provide loss protection to the owners of the loans serviced to hold capital against those loans;
- Require banking organizations that purchase subordinated interests in loans or pools of loans that absorb the first dollars of losses from those loans to hold capital against the subordinated interest plus all more senior interests; and
- Require banking organizations and thrifts that provide financial standby letters of credit or other guarantee-type arrangements for third-party assets that absorb the first dollars of losses from those assets to hold the same amount of capital that they would be required to hold under a recourse arrangement with equivalent risk exposure.

The Agencies are also publishing as an advance notice of proposed rulemaking (ANPR) a preliminary "multi-level approach," that would use credit ratings from nationally recognized statistical rating organizations to measure relative exposure to risk in rated securitized asset transactions and would allow the capital assessment to vary with the risk. The Agencies are also requesting comment in the ANPR on the need for a separate multi-level approach for unrated securitizations and on how such a system could be designed.

B. Purpose and Effect

Implementation of all aspects of this proposal, including one or more multi-level approaches for securitization transactions, would result in more consistent treatments of recourse and similar transactions among the Agencies, more consistent risk-based capital treatments for transactions involving similar risk, and capital requirements that more closely reflect a banking organization or thrift's relative exposure to credit risk. In particular, the proposed treatments of low-level recourse transactions, purchased loan servicing rights that provide loss protection, and purchased subordinated interests that absorb the first dollars of losses from the underlying assets would bring the capital requirements of the Banking Agencies into greater conformity with those of the OTS.

The proposal would allow banks and bank holding companies (banking organizations) to maintain lower amounts of capital against low-level recourse transactions. The proposal would also require higher amounts of risk-based capital to be maintained against certain direct credit substitutes, including, for banking organizations, purchased servicing rights that provide loss protection to the owners of the loans serviced and purchased subordinated interests that absorb the first dollars of losses from the underlying assets, and, for both banking organizations and thrifts, certain guarantee-type arrangements provided for third-party assets that absorb the first dollars of losses from those assets.

Additionally, the Agencies expect that a multi-level approach will provide a method for identifying participants in securitization transactions that are relatively insulated from credit risk and therefore eligible for reduced capital assessments.

The Agencies intend that any final rules adopted in connection with this notice of proposed rulemaking and advance notice of proposed rulemaking that result in increased risk-based capital requirements for banking organizations or thrifts would apply only to transactions that are consummated after the effective date of such final rules. The Agencies intend that any final rules adopted in connection with this notice that result in reduced risk-based capital requirements for banking organizations or thrifts would apply to all transactions outstanding as of the effective date of such final rules and to all subsequent transactions.

The Agencies believe that the proposed rule would satisfy the requirements of section 618(b)(3) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act, since the proposed rule would apply to multifamily residential property loans sold with recourse.

C. Background

1. Recourse and Direct Credit Substitutes

Asset securitization is the process by which loans and other receivables are pooled, reconstituted into one or more classes or positions, and then sold. Securitizations typically carve up the risk of credit losses from the underlying assets and distribute it to different parties. The "first dollar" loss or subordinate position is first to absorb credit losses, the "senior" investor position is last, and there may be one or more loss positions in between ("second dollar" loss positions). Each loss position functions as a credit enhancement for the more senior loss positions in the structure.

For residential mortgages that are sold through the federally sponsored mortgage programs, a federal government agency or federally sponsored agency guarantees the securities sold to investors. However, many of today's asset securitization programs involve nonmortgage assets and are not supported in any way by the federal government. Sellers of these privately securitized assets therefore provide other forms of credit enhancement—first and second dollar loss positions—to reduce investors' risk of loss.

Sellers may provide this credit enhancement themselves through

[1] The OTS is adding definitions for "public sector entity" and "standby-type letter of credit" to be consistent with the Banking Agencies.

[2] The OTS risk-based capital regulation already permits thrifts to hold reduced capital against low level recourse transactions and requires thrifts to treat purchased recourse servicing and certain purchased subordinated interests as recourse. 12 CFR 567.6(a)(2)(i)(C). The OTS is not proposing to amend these existing treatments.

recourse arrangements. For purposes of this notice, "recourse" refers to any risk of loss that an institution may retain in connection with the transfer of its assets. While banking organizations and thrifts have long provided recourse in connection with sales of whole loans or loan participations, recourse arrangements today are frequently associated with asset securitization programs.

Sellers may also arrange for a third party to provide credit enhancement in an asset securitization. If the third-party enhancement is provided by another banking organization or thrift, that institution assumes some portion of the assets' credit risk. For purposes of this proposal, all forms of third-party enhancements, *i.e.*, all arrangements in which an institution assumes risk of loss from third-party assets or other claims that it has not transferred, are referred to as "direct credit substitutes."[3] In economic terms, an institution's risk of loss from providing a direct credit substitute can be identical to its risk of loss from transferring an asset with recourse.

Depending upon the type of asset securitization, a portion of the total credit enhancement may also be provided internally, as part of the securitization structure, through the use of spread accounts, overcollateralization, or other forms of self-enhancement. Many asset securitizations use a combination of internal enhancement, recourse, and third-party enhancement to protect investors from risk of loss.

2. Prior History

On June 29, 1990, the Federal Financial Institutions Examination Council (FFIEC) published a request for comment on recourse arrangements. See 55 FR 26766 (June 29, 1990). The publication announced the Agencies' intent to review the regulatory capital, reporting and lending limit treatments of assets transferred with recourse and similar transactions, and set out a broad range of issues for public comment. The FFIEC received approximately 150 comment letters in response. The FFIEC then narrowed the scope of the review to the reporting and capital treatments of recourse arrangements and direct credit substitutes that expose banking organizations and thrifts to credit-related risks.

In July 1992, after receiving preliminary recommendations from an interagency staff working group, the FFIEC directed the staff to carry out a study of the likely impact of those recommendations on banking organizations and thrifts, financial markets and other affected parties. As part of that study, the staff held a series of meetings with representatives from thirteen organizations active in the securitization and credit enhancement markets. Summaries of the information provided to the staff and a copy of the staff's letter sent to participants prior to the meetings are in the FFIEC's public file on recourse arrangements and are available for public inspection and photocopying. Additional material provided to the Agencies from financial institutions and others since these meetings has also been placed in the FFIEC's public file.

The FFIEC's offices are located at 2100 Pennsylvania Avenue, NW., suite 200, Washington, DC 20037. For public convenience, the Agencies have also placed copies of all of the above material in the FRB's public file, located at 20th Street and Constitution Avenue, NW., Washington, DC 20551, room B–1122.

D. Current Risk-Based Capital Treatments of Recourse and Direct Credit Substitutes

Currently, the Agencies' risk-based capital standards apply different treatments to recourse arrangements and direct credit substitutes. As a result, capital requirements applicable to credit enhancements do not consistently reflect credit risk. The Banking Agencies' current rules are also not consistent with those of the OTS.

1. Recourse

a. *Banking agencies.* The Banking Agencies' risk-based capital guidelines prescribe a single treatment for assets transferred with recourse whether the transaction is reported as a financing or a sale of assets in a bank's Consolidated Reports of Condition and Income (Call Report). In either case, risk-based capital is held against the full, risk-weighted amount of the transferred assets, regardless of the amount of recourse that is provided.[4]

Assets transferred with any amount of recourse in transactions reported as financings remain on the balance sheet and continue to be subject to the full risk-based capital charge (based on their risk-weight).

Assets transferred with recourse in transactions that are reported as sales create off-balance sheet exposures. The entire outstanding amount of the assets sold (not just the amount of the recourse) is converted into an on-balance sheet credit equivalent amount using a 100% credit conversion factor.

This capital treatment differs from the accounting treatment for recourse arrangements under generally accepted accounting principles (GAAP) and is intended to ensure that banking organizations that transfer assets and retain the credit risk inherent in the assets maintain adequate capital to support that risk. As is explained below, the Banking Agencies believe that the GAAP accounting treatment would not provide sufficient capital to support recourse arrangements.

b. *OTS.* OTS follows GAAP in according sales treatment to sales with recourse for reporting purposes and for calculating the leverage ratios of thrifts. Under the OTS risk-based capital regulation, thrifts must also hold capital against the full value of assets transferred with recourse in computing their risk-based capital requirements, unless the capital charge would exceed the contractual maximum amount of the recourse provided. If the capital charge would exceed the amount of the recourse, then the thrift is only required to hold dollar-for-dollar capital against the contractual maximum amount of the recourse (the low-level recourse rule). (Footnote 17 below addresses the treatment of recourse liability accounts.)

2. Direct Credit Substitutes

a. *Banking agencies.* Direct credit substitutes are treated differently from recourse under the current risk-based capital standards. Under the Banking Agencies' guidelines, off-balance sheet direct credit substitutes, such as financial standby letters of credit provided for third-party assets, carry a 100% credit conversion factor. However, only the dollar amount of the direct credit substitute is converted into an on-balance sheet credit equivalent so that capital is held only against the face amount of the direct credit substitute. The capital requirement for a recourse arrangement, in contrast, is based on the full amount of the assets enhanced.

If a direct credit substitute covers less than 100% of the losses on the assets enhanced, the current capital treatment results in a lower capital charge for a direct credit substitute than for a comparable recourse arrangement. For example, if a direct credit substitute covers losses up to 20% of the amount of the assets enhanced, then the on-balance sheet credit equivalent amount equals that 20% amount. Risk-based capital is held against only the 20%

[3] As used in this preamble, the terms "credit enhancement" and "enhancement" refer to both recourse arrangements and direct credit substitutes.

[4] The Banking Agencies provide a limited exception to this treatment for sales of mortgage loan pools where the bank or bank holding company retains only minimal risk and meets certain other conditions.

amount. In contrast, required capital for a 20% recourse arrangement is higher because capital is held against the full outstanding amount of the assets enhanced.[5]

Under the Agencies' proposal, the definition of direct credit substitute would also be expanded to include some items that are already partially reflected on the balance sheet, such as purchased subordinated interests. Currently, under the Banking Agencies' guidelines, these interests receive the same capital treatment as off-balance sheet direct credit substitutes. Purchased subordinated interests are placed in the appropriate risk-weight category and then added to the banking organization's risk-weighted assets. In contrast, if a banking organization retains a subordinated interest in connection with the transfer of its own assets, this is considered recourse. The institution must hold capital against the carrying amount of the subordinated interest as well as the outstanding amount of all senior interests that it supports.

b. *OTS.* The OTS risk-based capital regulation treats some forms of direct credit substitutes (*e.g.*, financial standby letters of credit) the same as the Banking Agencies' guidelines. However, unlike the Banking Agencies, the OTS treats purchased subordinated interests under its general recourse provisions (except for certain high quality subordinated mortgage-related securities). The risk-based capital requirement is based on the carrying amount of the subordinated interest plus all senior interests, as though the thrift owned the full outstanding amount of the assets enhanced.

3. Problems With Existing Risk-Based Capital Treatments of Recourse Arrangements and Direct Credit Substitutes

The Agencies are proposing changes to the risk-based capital standards to address the following major concerns with the current treatments of recourse and direct credit substitutes:

- Different amounts of capital can be required for recourse arrangements and direct credit substitutes that expose a banking organization or thrift to equivalent risk of loss.
- The standards generally do not reduce the capital requirement for banking organizations that reduce their risk by transferring assets with low levels of recourse.
- The capital assessment rate does not recognize the difference in risk of loss between recourse or direct credit substitutes that absorb first losses and recourse or direct credit substitutes that absorb second losses from the underlying assets.
- The current standards do not provide uniform definitions of recourse, direct credit substitute, and associated terms.

E. GAAP Treatment of Recourse Arrangements

As was mentioned above, the Banking Agencies' regulatory capital treatment of asset transfers with recourse differs from the accounting treatment of asset transfers with recourse under generally accepted accounting principles (GAAP).[6] The Banking Agencies do not believe it would be appropriate to conform the regulatory capital treatment of recourse arrangements to GAAP.

Under GAAP, a transfer of receivables with recourse is accounted for as a sale if the transferor (1) surrenders control of the future economic benefits of the assets, (2) is able to reasonably estimate its obligations under the recourse provision, and (3) is not obligated to repurchase the assets except pursuant to the recourse provision. These provisions indicate that GAAP focuses on the transfer of benefits rather than the retention of risk in determining whether an asset transfer should be accounted for as a sale.

The transferor must accrue, as a separate liability, an amount sufficient to absorb all estimated probable losses under the recourse provision over the life of the assets transferred. This accrued amount is referred to as the GAAP recourse liability. If a banking organization reported assets transferred with recourse in accordance with GAAP, and no regulatory capital were required for the transaction, then the institution's only protection against losses would be the GAAP recourse liability account. For a number of reasons, the Banking Agencies are of the opinion that the GAAP recourse liability account would be an inadequate substitute for an appropriate level of regulatory capital.

First, the GAAP recourse liability account is intended to cover only an institution's probable expected losses under the recourse provision. In contrast, regulatory capital is intended to provide a cushion against unexpected losses. In recognition of the distinctly different purposes of the GAAP recourse liability account and regulatory capital, the Banking Agencies explicitly exclude the GAAP recourse liability account from regulatory capital.

Second, the amount of credit risk that is typically retained in a recourse transaction greatly exceeds the normal, expected losses associated with the transferred assets. Even though a transferor may reduce its exposure to potential catastrophic losses by limiting the amount of recourse it provides, in many cases the transferor still retains the bulk of the risk inherent in the assets.

For example, if an institution transfers high quality assets with 10% recourse that have a reasonably estimated loss rate of 1%, the transferor retains the risk of default up to a maximum of 10% of the total amount of the assets transferred. Because the recourse provision represents exposure to such a high amount of losses relative to the expected losses, in the normal course of business the transferor will sustain the same amount of losses as if the assets had not been sold. Consequently, the Banking Agencies take the position that the transferor in this example has not significantly reduced its risk for purposes of assessing regulatory capital and should continue to be assessed regulatory capital as though the assets have not been transferred.

Third, the GAAP reliance on reasonable estimates of all probable credit losses over the life of the receivables transferred poses additional concerns for the Banking Agencies. While it may be possible to make such estimates for pools of consumer loans or residential mortgages, the Banking Agencies are of the view that it is difficult to do so for other types of loans. Even if it is possible to make a reasonable estimate of probable credit losses at the time an asset or asset pool is transferred, the ability of an institution to make a reasonable estimate may change over the life of the transferred assets.

Finally, the Banking Agencies are concerned that an institution transferring assets with recourse might estimate that it would not have any losses under the recourse provision, in which case it would not establish any GAAP recourse liability account for the exposure. If the transferor recorded either no liability or only a nominal liability in the GAAP recourse liability account for a succession of asset transfers, a cumulation of credit risk

[5] If the direct credit substitute covers 100% of losses on the assets enhanced, then the current capital treatment results in the same capital charge for a direct credit substitute as for an asset sold with recourse. The direct credit substitute is converted into an on-balance sheet credit equivalent equal to 100% of the assets enhanced and capital is required against that amount.

[6] The OTS requires thrifts to account for assets sold with recourse in accordance with GAAP for reporting purposes and leverage capital requirements, but assesses capital against assets sold with recourse in computing the risk-based capital requirement for thrifts.

would occur that would not be reflected, or would be only partially reflected, on the balance sheet.

II. Notice of Proposed Rulemaking

The Agencies' proposal to amend the risk-based capital standards would do the following:

- Define the term "recourse," expand the definition of the existing term "direct credit substitute," and define the associated terms "standard representations and warranties" and "servicer cash advance";
- Reduce the Banking Agencies' risk-based capital assessment for certain low-level recourse arrangements; and
- Require equivalent treatment of recourse arrangements and certain direct credit substitutes that present equivalent risk of loss, including
  - —requiring banking organizations that purchase certain loan servicing rights which provide loss protection to the owners of the loans serviced to hold capital against those loans,
  - —requiring banking organizations that purchase subordinated interests which absorb the first dollars of losses from the underlying assets to hold capital against the subordinated interest plus all more senior interests, and
  - —requiring banking organizations and thrifts that provide financial standby letters of credit or other guarantee-like arrangements for third-party assets that absorb the first dollars of losses from those assets to hold capital against the outstanding amount of the assets enhanced.[7]

A. Definitions of Recourse and Direct Credit Substitute

1. Recourse

The proposal defines "recourse" to mean any risk of loss that a banking organization or thrift *retains* in connection with an asset transfer, if the risk of loss exceeds a pro rata share of the institution's claim on the assets.[8] The proposed definition of recourse is consistent with the Banking Agencies' longstanding use of this term, and is intended to incorporate into the risk-based capital standards existing Agency practices regarding retention of risk in asset transfers.[9]

Currently, the term "recourse" is not explicitly defined in the Banking Agencies' risk-based capital guidelines. Instead, the guidelines use the term "sale of assets with recourse," which is defined by reference to the Call Report instructions. See Call Report instructions, Glossary (entry for "Sales of Assets"). Once a definition of recourse is adopted in the risk-based capital guidelines, the Banking Agencies would delete the cross-reference to the Call Report instructions and would recommend to the FFIEC that these instructions be revised to incorporate the risk-based capital definition of recourse. The OTS capital regulation currently provides a definition of the term "recourse," which would also be replaced once a final definition of recourse is adopted.

2. Direct Credit Substitute

The proposed definition of "direct credit substitute" is intended to mirror the definition of recourse. The term "direct credit substitute" would refer to any arrangement in which an institution *assumes* risk of loss from assets or other claims it has not transferred, if the risk of loss exceeds the institution's pro rata share of the assets or other claims. Currently, under the Banking Agencies' guidelines, this term covers guarantees and guarantee-type arrangements. As revised, it would also explicitly include items such as purchased subordinated interests and agreements to cover credit losses that arise from purchased loan servicing rights.

3. Risks Other Than Credit Risks

These definitions cover arrangements that create exposure to all types of risk. However, a capital charge would be assessed only against arrangements that create exposure to credit or credit-related risks. This continues the Agencies' current practice and is consistent with the risk-based capital standards' current, primary focus on credit risk.

4. Implicit Recourse

The definitions cover all arrangements that are recourse or direct credit substitutes, in form or in substance. This continues the Banking Agencies' current treatment of recourse under the Call Report instructions.[10] Recourse exists in substance, or implicitly, when an institution demonstrates a pattern of providing recourse even though it has no legal obligation to do so. For example, an institution that regularly buys back or replaces problem assets when it is not required to do so under the terms of the sale agreement may be providing recourse. The Agencies will continue their current practice of requiring institutions that demonstrate a pattern of providing implicit recourse to treat those transactions and all similar outstanding transactions as recourse for risk-based capital purposes. The Agencies will follow the same approach, as appropriate, for direct credit substitutes. Decisions concerning implicit recourse or implicit direct credit substitute arrangements will be made on a case-by-case basis.

5. Subordinated Interests in Loans or Pools of Loans

The definitions explicitly cover an institution's ownership of subordinated interests in loans or pools of loans. This continues the Banking Agencies' longstanding treatment of retained subordinated interests as recourse and recognizes that purchased subordinated interests can also function as credit enhancements. Subordinated interests generally absorb more than their pro rata share of losses (principal or interest) from the underlying assets in the event of default.[11] For example, a multi-class asset securitization may have several classes of subordinated securities, each of which provides credit enhancement for the more senior classes. Generally, the holder of any class that absorbs more than its pro rata share of losses from the total underlying assets is providing recourse or a direct credit substitute for all more senior classes.[12]

6. Second Mortgages

Second mortgages or home equity loans would generally not be considered recourse or direct credit substitutes, unless they actually functioned as credit

[7] The OTS currently treats purchased loan servicing rights and purchased subordinated interests as recourse. This treatment would not change under this proposal.

[8] If the institution transfers an asset or pool of assets in whole or in part but shares the total credit risk from the assets on a pro rata basis with the purchaser, this is not considered recourse. In such transactions, capital is required only against the transferor's pro rata share. Recourse exists when the transferor retains a disproportionate amount of the credit risk relative to its retained interest (if any) in the assets.

[9] The OTS currently defines the term "recourse" more broadly than the proposal to include credit risk that a thrift assumes or accepts from third-party assets as well as risk that it retains in an asset transfer. Under the proposal, as explained below, credit risk that a banking organization or thrift assumes from third-party assets would fall under the definition of "direct credit substitute" rather than "recourse."

[10] See Call Report Instructions, Glossary—Sales of Assets: Interpretations and illustrations of the general rule ¶1, A–49 (May 1989) (retention of risk depends on the substance of the transaction, not the form).

[11] A class of securities that receives payments of principal (and, in some cases, interest) only after another class or classes from the same issue is completely paid is generally not considered recourse or a credit substitute, provided that losses are shared on a pro rata basis in the event of default.

[12] Current OTS risk-based capital guidelines exclude certain high-quality subordinated mortgage-related securities from treatment as recourse arrangements due to their credit quality. OTS is not proposing to change this treatment.

enhancements by facilitating the sale of the first mortgage. This is most likely to occur if a lender originates first and second mortgages contemporaneously on the same property and then sells the first mortgage and retains the second. In such a transaction, the second mortgage would function as a substitute for a recourse arrangement because it is intended that the second mortgage will absorb losses before the first mortgage does if the borrower fails to make all payments due on both loans. Under the proposal, a second mortgage that is originated at or about the same time as the first mortgage would be presumed to be a recourse arrangement or direct credit substitute unless the holder was able to demonstrate that the second mortgage was granted for some purpose other than providing credit enhancement for the first mortgage (e.g., home improvement loans).

(Question 1) The Agencies specifically request comment on this proposed treatment and on whether additional factors should be considered in determining whether a second mortgage provides recourse or a direct credit substitute.

7. Representations and Warranties

When a banking organization or thrift transfers assets, including servicing rights, it customarily makes representations and warranties concerning those assets. When a banking organization or thrift purchases loan servicing rights, it may also assume representations and warranties made by the seller or a prior servicer. These representations and warranties give certain rights to other parties and impose obligations upon the seller or servicer of the assets. The definitions would treat as recourse or direct credit substitutes any representations or warranties that create exposure to default risk or any other form of open-ended, credit-related risk from the assets that is not controllable by the seller or servicer. This reflects the Agencies' current practice with respect to recourse arising out of representations and warranties, and explicitly recognizes that a servicer with purchased loan servicing rights can also take on risk through servicer representations and warranties.

The Agencies recognize, however, that the market requires asset transferors and servicers to make certain representations and warranties, and that most of these present only normal, operational risk. Currently, the Agencies have no formal standard for distinguishing between these types of representations and warranties and those that create recourse or direct credit substitutes. The proposal therefore defines the term "standard representations and warranties" and provides that seller or servicer representations or warranties that meet this definition would not be considered recourse or direct credit substitutes.

Under the proposal, "standard representations and warranties" are those that refer to an existing state of facts that the seller or servicer can either control or verify with reasonable due diligence at the time the assets are sold or the servicing rights are transferred. These representations and warranties will not be considered recourse or direct credit substitutes, provided that the seller or servicer performs due diligence prior to the transfer of the assets or servicing rights to ensure that it has a reasonable basis for making the representation or warranty. The term "standard representations and warranties" would also cover contractual provisions that permit the return of transferred assets in the event of fraud or documentation deficiencies, (i.e., if the assets are not what the seller represented them to be), consistent with the current Call Report instructions governing the reporting of asset transfers. After a final definition of "standard representations and warranties" is adopted for the risk-based capital standards, the Banking Agencies would recommend to the FFIEC that the Call Report instructions be changed to conform to the capital guidelines and the OTS would similarly amend the instructions for the Thrift Financial Report (TFR).

Examples of "standard representations and warranties" include seller representations that the transferred assets are current (i.e., not past due) at the time of sale; that the assets meet specific, agreed-upon credit standards at the time of sale; or that the assets are free and clear of any liens (provided that the seller has exercised due diligence to verify these facts). An example of a nonstandard representation and warranty would be a contractual provision stating that all properties underlying a pool of transferred mortgages are free of environmental hazards. This representation is not verifiable by the seller or servicer with reasonable due diligence because it is not possible to absolutely verify that a property is, in fact, free of all environmental hazards. Such an open-ended guarantee against the risk that unknown but currently existing hazards might be discovered in the future would be considered recourse or a direct credit substitute. However, a seller's representation that all properties underlying a pool of transferred mortgages have undergone environmental studies and that the studies revealed no known environmental hazards would be a "standard representation and warranty" (assuming that the seller performed the requisite due diligence). This is a verifiable statement of facts that would not be considered recourse or a direct credit substitute.

8. Loan Servicing Arrangements

The definitions cover loan servicing arrangements if the servicer is responsible for credit losses associated with the loans being serviced. However, cash advances made by servicers to ensure an uninterrupted flow of payments to investors or the timely collection of the loans would be specifically excluded from the definitions of recourse and direct credit substitute, provided that the servicer is entitled to reimbursement for any significant advances.[13] Such advances are assessed risk-based capital only against the amount of the cash advance, and are assigned to the risk-weight category appropriate to the party that is obligated to reimburse the servicer.

If the servicer is not entitled to full reimbursement, then the maximum possible amount of any nonreimbursed advances on any one loan must be contractually limited to an insignificant amount of the outstanding principal on that loan in order for the cash advance to be excluded from the definitions of recourse and direct credit substitute. This treatment reflects the Agencies' traditional view that servicer cash advances meeting these criteria are part of the normal servicing function and do not constitute credit enhancements.

B. Low-level recourse rule

The Banking Agencies are proposing to reduce the capital requirement for all recourse transactions in which a banking organization contractually limits its exposure to less than the full, effective risk-based capital requirement for the assets transferred (referred to as "low-level recourse transactions").[14] This proposal would apply to low-level recourse transactions involving all types of assets, including small business loans, commercial loans and residential mortgages.

[13] Servicer cash advances would include disbursements made to cover foreclosure costs or other expenses arising from a loan in order to facilitate its timely collection (but not to protect investors from incurring these expenses).

[14] The "full effective risk-based capital charge" is 8% for 100% risk-weighted assets and 4% for 50% risk-weighted assets.

1. "Dollar-for-dollar" Capital Requirement Up to the Amount of the Recourse Obligation for Low-Level Recourse

Under the proposed low-level recourse rule, a banking organization that contractually limits its maximum recourse obligation to less than the full effective risk-based capital requirement for the transferred assets would be required to hold risk-based capital equal to the contractual maximum amount of its recourse obligation. This would be a "dollar-for-dollar" capital requirement for the low-level recourse exposure. For example, the risk-based capital requirement for a 100% risk-weighted asset transferred with 3% recourse would be only 3% of the value of the transferred assets rather than the currently required 8%. This would prevent a banking organization's capital requirement from exceeding the contractual maximum amount that it could lose under a recourse obligation.[15] In addition, adoption of this proposal would bring the Banking Agencies into conformity with the OTS, which already applies the low-level recourse rule to thrifts.

The Agencies will continue to evaluate the need for full capital support for low-level recourse transactions and will consider, in connection with development of the multi-level approaches that are discussed in Section III, whether even greater reductions in the capital requirement for low-level recourse transactions should be proposed.

2. Low-level Recourse Arrangements for Mortgage-Related Securities or Participation Certificates Retained in a Mortgage Loan Swap

When an institution swaps mortgage loans for mortgage-related securities or participation certificates and retains low-level recourse, the Banking Agencies currently base the capital requirement on the underlying loans as if the loans were held as on-balance sheet assets. The OTS bases the capital requirement for these arrangements on its existing low-level recourse rule, with a minimum capital level of 1.6% of the mortgage-related securities or participation certificates. (These certificates would include only high-quality mortgage related securities.)

To recognize the risks related to such a participation certificate and the retained recourse, the Agencies propose to change their capital requirement for this arrangement. The requirement would equal the sum of the amount of risk-based capital required for the portion of the mortgage-related security or participation certificate not covered by the institution's recourse obligation and the risk-based capital required for the low-level recourse obligation retained on the underlying loans, limited to the capital requirement for the underlying loans as if the loans were held as on-balance sheet assets.

For example, if an institution swaps $1,000 of qualifying single-family mortgage loans for a Freddie Mac participation certificate and retains 1% recourse, the proposed capital requirement would equal the sum of the following:

(1) $1,000 times (100% minus 1%)[16] times 20% risk-weight times 8% = $15.84, and

(2) $1,000 times 1% = $10

This sum, $25.84, is limited by the capital requirement on the underlying loans as if they were held by the institution. This limit is 4% of $1,000 or $40. Thus, since the sum, $25.84, is less than the limit, $40, the capital requirement is $25.84.

3. Reporting of Low-Level Recourse Transactions

The Banking Agencies are also proposing to recommend to the FFIEC that banks be permitted to report low-level recourse transactions as sales of assets (rather than financings) in the Call Report, if they establish and maintain a recourse liability account for the contractual maximum amount of the recourse obligation. (Otherwise, these transactions would continue to be reported as financings in the Call Report.) The recourse liability account could be established either by a charge to expense or to the allowance for loan and lease losses, as appropriate. The recourse liability account would not be part of the allowance for loan and lease losses and would therefore be excluded from the bank's capital base. Banks that fully reserve against their recourse exposure in this manner would not be assessed any risk-based capital for the transaction, which would be consistent with the current treatment of such transactions for thrifts. The accounting entries which permit the removal of the assets from a bank's balance sheet on the condition that the low-level risk exposures are either expensed or fully reserved for (either of which produces a change in the bank's equity capital position) result in an appropriately adjusted leverage capital ratio.

The Banking Agencies currently permit banks to report as sales in the Call Report certain residential and agricultural mortgage transfers with recourse that qualify as sales under GAAP. The FRB requires bank holding companies to report all asset sales with recourse in accordance with GAAP on the consolidated financial statement for bank holding companies (Form FR Y-9C). The OTS requires thrifts to report all transfers of receivables with recourse in accordance with GAAP on their TFRs. The Agencies are not proposing to change these existing regulatory reporting treatments.

4. GAAP Recourse Liability Account

As previously explained, under GAAP, when a transfer of receivables with recourse qualifies to be recognized as a sale, the seller must establish a recourse liability account at the date of sale that covers all probable credit losses under the recourse provision over the life of the receivables transferred.

(Question 2) The Banking Agencies request comment on how the GAAP recourse liability account should be treated under the proposed low-level recourse rule for transfers of receivables with recourse that are currently reported as sales in the Call Report and FR Y-9C.[17] That is, when a banking organization transfers assets in such transactions, should the amount of capital required under the low-level recourse rule be adjusted to take account of the institution's GAAP recourse liability account?

The two options are: (1) Not taking the GAAP recourse liability account into consideration at all; or (2) requiring risk-based capital equal to the amount of the banking organization's low-level recourse obligation minus the balance of its GAAP recourse liability account so that the recourse liability account plus required capital would equal the banking organization's contractual maximum exposure under the recourse

[15] The proposed low-level recourse rule would supersede the Banking Agencies' current risk-based capital treatment of mortgage transfers with "insignificant" recourse. Under that treatment, the sale of a residential mortgage with recourse is excluded from risk-weighted assets if the institution does not retain significant risk of loss, i.e., the institution's maximum contractual recourse exposure does not exceed its reasonably estimated probable losses on the transferred mortgages, and the institution establishes and maintains a recourse liability account equal to the amount of its recourse obligation.

[16] This 99% piece is the portion of the loan pool not covered by the institution's recourse obligation, which is guaranteed by Freddie Mac. For operational simplicity, 100% may be used to determine an institution's capital requirement.

[17] The OTS is not proposing to change its current policy, which permits a thrift to deduct the amount of its GAAP recourse liability account (1) from the contractual maximum amount of its recourse obligation in applying the low-level recourse rule, and (2) from the amount of loans sold with recourse in assessing the full effective risk-based capital requirement for all loans.

obligation.[18] The latter option would conform the Banking Agencies' treatment to that of the OTS in this area.

The Banking Agencies' existing risk-based capital guidelines also do not indicate how the GAAP recourse liability account should be taken into account in general when determining the credit equivalent amounts of assets transferred with recourse that are currently reported as sales in the Call Report or FR Y–9C. The Banking Agencies expect to apply the GAAP recourse liability account treatment that they adopt for low-level recourse transactions that are reported as sales in the Call Report or FR Y–9C to all asset transfers with recourse that are currently reported as sales in the Call Report or FR Y–9C, and to clarify their risk-based capital guidelines accordingly.

C. Treatment of Direct Credit Substitutes

The Agencies are proposing to extend the current risk-based capital treatment of asset transfers with recourse (including the proposed low-level recourse rule) to certain direct credit substitutes. As previously explained, the current risk-based capital assessment for a direct credit substitute may be dramatically lower than the assessment for a recourse provision that creates an identical exposure to risk. Based on the Agencies' conclusion that asset transfers with recourse should be assessed risk-based capital against the full amount of the assets enhanced [19] (except in low-level recourse transactions), the Agencies are of the opinion that direct credit substitutes that present equivalent risk should be subject to an equivalent risk-based capital treatment.

Under this proposal, the general treatment of direct credit substitutes would be to assess capital against the amount of the asset or pool of assets that is enhanced, rather than the face amount of the direct credit substitute. Like low-level recourse arrangements, direct credit substitutes that cover only losses below the full effective risk-based capital requirement for the assets would be assessed a dollar-for-dollar capital requirement.[20]

The proposed treatment of direct credit substitutes would not affect the current treatment of purchased subordinated interests and financial standby letters of credit that absorb only the second dollars of losses from the assets enhanced.[21] The Agencies intend to determine the appropriate risk-based capital treatment of these second dollar loss direct credit substitutes as part of the development of the multi-level approaches discussed in Section III. In the event that the Agencies do not proceed with implementation of one or more multi-level approaches, the Agencies would expect to propose amendments to the risk-based capital standards that would assess risk-based capital against all second dollar loss direct credit substitutes based on their face amounts plus the face amounts of all more senior outstanding positions.

The currently proposed change to the treatment of direct credit substitutes would primarily affect the following transactions:

- Loan servicing rights purchased by banking organizations if they embody a direct credit substitute,
- Subordinated interests purchased by banking organizations that absorb the first dollars of losses from the underlying loans or pools of loans, and
- Financial standby letters of credit and other guarantee-like arrangements provided by banking organizations or thrifts that absorb the first dollars of losses from third-party assets.

Each of these is discussed below.

1. Purchased Loan Servicing Rights That Embody a Direct Credit Substitute

Banking organizations and thrifts that sell receivables often retain the servicing rights on the transferred assets. Banking organizations and thrifts may also acquire loan servicing rights as separate assets such as purchased mortgage servicing rights. The terms of some loan servicing agreements require the servicer to absorb credit losses on the loans, so that the servicer effectively extends a credit enhancement (in the form of recourse or a direct credit substitute) to the owners of the loans.

Currently, all of the Agencies treat as recourse retained loan servicing rights that embody an obligation to provide credit or other loss protection to the owners of the loans. Accordingly, risk-based capital is required against the full amount of the assets serviced.

Under the Banking Agencies' proposal, banking organizations with purchased loan servicing rights that extend credit protection (a direct credit substitute) to the owners of the loans being serviced would also be required to hold capital against the total outstanding amount of those loans.[22] Thus, banking organizations that purchase such servicing rights would be required to apply the 100% credit conversion factor to the amount of assets enhanced (the amount of the loans serviced) to convert this off-balance sheet exposure into an on-balance sheet credit equivalent amount.[23]

The proposed low-level recourse rule would apply if the servicer's maximum retained recourse obligation is contractually limited to an amount that is less than the amount of capital that would be required against the total amount of the loans serviced.

(Question 3) The Agencies request comment on whether purchased loan servicing rights agreements exist that obligate the servicer to provide credit loss protection for only the second dollars of losses from the loans. In determining a servicer's loss position, the Agencies do not consider access to loan collateral upon default to place the servicer in a second loss position.

Adoption of the proposal would align the Banking Agencies' treatment of purchased loan servicing rights that embody a direct credit substitute with that of the OTS, which already explicitly requires capital support for these arrangements.[24] Currently, the FDIC and OCC do not explicitly require capital support for these arrangements.[25] (Capital is required for the allowed portion of the intangible asset generated by the purchase of mortgage servicing rights, but not for the servicer's separate risk of loss on the underlying loans). The FRB considers purchased mortgage

[18] The GAAP recourse liability account must be excluded from an institution's risk-based and leverage capital base.

[19] See earlier comparison to GAAP accounting requirements.

[20] As indicated in Section II(B), the Agencies are continuing to evaluate the need for a dollar-for-dollar capital requirement on low-level recourse transactions. Any modification to the proposed treatment of low level recourse transactions would also apply to low level direct credit substitutes (*i.e.*, those that cover losses below the full, effective risk-based capital charge for the total outstanding amount of the assets enhanced). See Section III for additional discussion.

[21] For purposes of this proposal, and until the Agencies implement one or more multi-level approaches, a direct credit substitute absorbs the second dollars of losses from assets if there is prior credit enhancement that absorbs first dollars of losses from those assets. For OTS only, purchased subordinated interests whether in the first or second loss position will continue to be treated as recourse.

[22] The OTS already requires thrifts to hold capital against the total outstanding amount of these loans.

[23] The risk-based capital requirement for the servicer's exposure to credit risk from the loans would be in addition to the separate risk-based capital requirement that is currently required to support qualifying intangible assets under the risk-based capital standards.

[24] The OTS capital regulation provides that "loans serviced by associations where the association is subject to losses on the loans, commonly known as recourse servicing," are to be converted at 100% to an on-balance sheet credit equivalent. 12 CFR 567.6(a)(2)(i)(C).

[25] The Agencies are not at this time addressing the risk-based capital treatment of servicing rights associated with mortgage pools that back securities guaranteed by the Government National Mortgage Association.

servicing rights that provide credit protection to be a direct credit substitute and requires capital support for the risk associated with the underlying mortgage loans. Thus, the proposal would make this treatment explicit in the FRB's guidelines.

2. Purchased Subordinated Interests

The proposal would extend the current risk-based capital treatment of retained subordinated interests to purchased subordinated interests that absorb the first dollars of losses from the underlying loans or loan pools. Currently, banking organizations with purchased subordinated interests are required to hold risk-based capital only against the carrying value of the subordinated interest. In contrast, the OTS currently treats purchased subordinated interests in the same manner as retained subordinated interests, *i.e.*, as recourse, except for certain high quality subordinated interests.[26]

Under this proposal, banking organizations with direct credit substitutes in the form of purchased subordinated interests that absorb the first dollars of losses from the underlying assets would be required to hold risk-based capital against the carrying value of the subordinated interest plus the outstanding amount of all more senior interests that the subordinated interest supports.[27] If the carrying value of the most subordinated portion of the loan, or pool of loans, is less than the full, effective risk-based capital requirement for the total underlying loan, or pool of loans, then the low-level treatment would apply, *i.e.*, the subordinated portion would be assessed risk-based capital dollar-for-dollar against its carrying value. For example, if the most subordinated portion of a pool of mortgage assets that qualifies for the 50% risk-weight is held by a banking organization and its carrying value represents only 3% of the total pool, the capital requirement for the subordinated portion would be 3% of the total pool rather than 4% (*i.e.*, the carrying value of the subordinated portion rather than the full effective capital requirement for the pool).

The Banking Agencies' risk-based capital treatment of purchased subordinated interests that represent middle or mezzanine level loss positions in terms of exposure to total losses from the assets (*i.e.*, purchased subordinated interests that absorb losses only after prior enhancements that absorb the first dollars of losses have been fully exhausted) would not be affected by this proposal.[28] Risk-based capital would continue to be assessed at the 100% risk-weight against the carrying value of this type of purchased subordinated interest.

3. Financial Standby Letters of Credit and Guarantee-Like Arrangements

The proposal would extend the risk-based capital treatment that is currently applied to asset transfers with recourse to financial standby letters of credit and guarantee-like arrangements that absorb the first dollars of losses from third-party assets. The risk-based capital assessment for this form of credit enhancement would be based on the full amount of the assets enhanced rather than the face amount of the standby letter of credit or guarantee-like arrangement.

The risk-based capital treatment of standby letters of credit or guarantee-like arrangements that represent second dollar loss enhancements provided for third-party assets would not be affected by this proposal. For purposes of this part of the proposal, a second dollar loss standby letter of credit or guarantee-like arrangement is one that covers any percentage portion of loss after some level of the first dollars of loss is covered by another party or through internal enhancement (*e.g.*, losses from 6 to 20% of the asset value when another party provides first dollar loss enhancement that covers losses from 0 to 6% of the asset value[29]). These second dollar loss direct credit substitutes would continue to be assessed risk-based capital based on their risk-weighted face amounts.

The proposed rule also addresses participations in financial standby letters of credit and guarantee-like arrangements.

D. Summary

The proposal would increase capital requirements for first dollar loss financial standby letters of credit and guarantee-like arrangements that cover less than 100% of the face value of the total assets enhanced. There would be no change, however, in the risk-based capital requirement for arrangements that cover the entire amount of losses from a third party's assets, because the current guidelines already require capital to be held against the full asset amount in such direct credit substitute transactions. Based on Agency staff discussions with market participants, the Agencies believe that the majority of first dollar loss financial standby letters of credit and similar arrangements that are provided by banking organizations and thrifts in the current market are of this latter type. Thus, the Agencies do not expect that many banking organizations or thrifts would face increased risk-based capital requirements as a result of this aspect of the proposal.

Moreover, as was previously mentioned, the Agencies are considering options for matching the risk-based capital requirement more closely to the risk associated with second dollar loss subordinated interests and financial standby letters of credit and guarantee-like arrangements in connection with the development of one or more multi-level approaches. The multi-level approaches, in conjunction with the proposed rules above, would ensure that banking organizations maintain adequate capital against the risks associated with credit enhancements, would recognize when an institution has reduced its risk, and make capital treatment more consistent across the various types of depository institutions.

III. Advance Notice of Proposed Rulemaking

Many asset securitizations carve up the risk of credit losses from the underlying assets and distribute it to different parties. The first dollar loss or subordinate position is first to absorb credit losses, the senior investor position is last, and there may be one or more loss positions in between. Each loss position functions as a credit enhancement for the more senior loss positions in the structure. Currently, the risk-based capital standards do not vary the rate of capital assessment with differences in credit risk represented by different credit enhancement or loss positions.

[26] The OTS will continue to recognize the 20 percent risk-weight for high quality residential mortgage-backed senior and subordinated interests that qualify under the Secondary Mortgage Market Enhancement Act of 1984 (SMMEA), Section 3(a)(41) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(41), except as discussed in Regulatory Bulletin 26. These types of securities are commonly referred to as "SMMEA securities."

[27] If the subordinated portion of the loan, or pool of loans, is held by several banking organizations or thrifts, each institution would be required to hold risk-based capital against the carrying value of its subordinated interest plus its proportionate share of all more senior interests that the subordinated interest supports.

[28] The OTS would continue to treat such purchased subordinated interests (except for SMMEA securities) as recourse.

[29] If the enhancement is a back-up for the 0 to 6% coverage (*i.e.*, the first party covers the first 6% of losses and the second party covers the first 20% of losses but expects to absorb losses at the 0 to 6% level only if the first party fails to perform), then this is not a "second dollar loss" enhancement. The second party has exposure to the risk that the first party will not perform and would be charged capital for that exposure at the risk-weight appropriate for claims against the first party.

To address this issue, the Agencies are requesting comment on a preliminary proposal to adopt a multi-level approach that would assess risk-based capital against all banking organization and thrift participants in certain asset securitizations (*i.e.*, recourse providers, direct credit substitute providers and investors) based on their relative exposure to risk of loss from the underlying assets. Credit ratings from nationally recognized statistical rating organizations would be used to determine relative exposure to risk of loss. This proposal, referred to as the ratings-based multi-level approach, would permit reduced risk-based capital assessments for second dollar loss credit enhancers (both recourse and direct credit substitute providers) and for senior investors in eligible securitization transactions.[30] The Agencies also seek comment on whether a multi-level approach is needed for unrated securitization transactions and, if so, on how such a system could be designed.

A. *Ratings-Based Multi-Level Approach*

1. Threshold Criteria

The ratings-based multi-level approach would be restricted to transactions involving the securitization of large, diversified asset pools in which all forms of first dollar loss credit enhancement are either completely free of third-party performance risk (*i.e.*, the inability of the credit enhancer to perform) or are provided internally as part of the securitization structure, as specified below. The diversification requirement and the requirement that all first dollar loss credit enhancement be free from third-party performance risk are intended to protect the first dollar loss enhancement from default risk associated with any single party. For purposes of applying a multi-level approach, it is important to minimize the possibility that the first dollar loss enhancement will be exhausted because the presence of this prior enhancement will be the basis, in most transactions, for allowing lower risk-based capital assessments on the second dollar loss and senior positions.

For a transaction to qualify for the ratings-based multi-level approach, the first dollar loss credit enhancement could be provided in any of the following four ways:

- Cash collateral accounts;[31]
- Subordinated interests or classes of securities;
- Spread accounts, including those that are funded initially with a loan that is repaid from excess cash flows;[32] and
- Other forms of overcollateralization involving excess cash flows, *e.g.*, placing excess receivables into the pool so that total cash flows expected to be received exceed cash flows needed to pay investors.

Cash collateral accounts and subordinated interests are free of third-party performance risk because they stand ready to absorb a given percentage of total losses from the underlying assets regardless of the financial condition of the party that funds the cash collateral account or holds the subordinated interest. Spread accounts and other forms of overcollateralization can provide a similar type of insulation from exposure to any one party if the asset securitization is based on a large, well diversified pool of assets. These forms of internal credit enhancement depend on expected excess cash flows from the underlying assets and thus are subject to the risk that the excess cash may not materialize if default rates among the underlying borrowers exceed expectations. Restricting application of the ratings-based multi-level approach to large, well diversified asset pools is intended to minimize this risk.

Transactions with first dollar loss credit enhancements that are subject to third-party performance risk, such as financial standby letters of credit or repurchase obligations (which are subject to the risk that the provider fails to perform), and transactions that do not involve the securitization of large, well diversified asset pools would not be eligible for the ratings-based multi-level approach. Banking organizations and thrifts that participate as credit enhancers or investors in these types of securitization transactions would not be eligible for the reduced risk-based capital assessments available under this approach.

2. Risk-Based Capital Treatment of First Dollar Loss Positions

The risk-based capital treatment of credit enhancements provided by banking organizations or thrifts in transactions that qualify for the ratings-based multi-level approach would depend on the loss position of the credit enhancement. First dollar loss enhancements, whether provided as recourse or direct credit substitutes, would be required to hold capital dollar-for-dollar against their face amount, up to the full, effective risk-based capital requirement for the outstanding amount of the assets enhanced.[33] This would essentially incorporate the proposed low-level recourse rule into the treatment of first dollar loss enhancements under the ratings-based multi-level approach. The dollar-for-dollar capital requirement would apply to the holders of subordinated interests as well as against the providers of loans used to fund either cash collateral accounts or spread accounts.[34]

As previously noted, the Agencies are continuing to evaluate the risk-based capital requirements for low-level recourse arrangements and low-level direct credit substitutes. Because the proposed treatment of first dollar loss positions under the ratings-based multi-level approach incorporates the low-level recourse rule, any modification of the low-level recourse rule would also affect the proposed treatment of first dollar loss positions. The capital requirement for these positions should reflect the fact that they generally carry a higher probability of loss relative to other loss positions in the securitization. However, the Agencies also recognize that the capital requirement for these positions may appear to be excessive because the probability of total loss for low-level recourse positions is unlikely to be 100 percent.

Consequently, the Agencies request comment on the proposed treatment of low-level recourse and direct credit substitute transactions and of first dollar loss positions. In particular, the Agencies invite comment on the following questions:

(Question 4) Is the proposed dollar-for-dollar capital requirement (up to the full, effective risk-based capital requirement for the underlying assets) too high for low-level recourse and

[30] The reduction in the risk-based capital charge for second dollar loss enhancements would be in relation to the treatment that the Agencies are considering proposing for second dollar loss direct credit substitutes that do not qualify for the ratings-based multi-level approach (see discussion below).

[31] A cash collateral account is a separate account funded with a loan from the provider of the enhancement. Funds in the account are available to cover potential losses.

[32] A spread account is typically a trust or special account that the issuer establishes to retain interest rate payments in excess of the amounts due investors from the underlying assets, plus a normal servicing fee rate. The excess spread serves as a cushion to cover potential losses on the underlying loans.

[33] See note 13. In no event would a single institution be required to hold capital in excess of the amount that would be required for the full amount of the assets underlying the securitization.

[34] First dollar loss enhancement provided through overcollateralization or a spread account (after any banking organization or thrift's initial loan to that account is repaid) does not impose risk of loss on any banking organization or thrift (assuming it is not capitalized in any fashion) and would therefore not be subject to an explicit risk-based capital charge.

direct credit substitute transactions or for first dollar loss positions? If so, why?

(Question 5) If this proposed capital requirement is too high, how can this be demonstrated or quantified? What methodology could be used to reduce the capital requirement without jeopardizing safety and soundness?

(Question 6) If less than dollar-for-dollar capital is required for low-level or other first dollar loss positions, then the probability of loss to the insurance funds increases. How should the Agencies deal with this increased probability of loss?

3. Risk-Based Capital Treatment of Second Dollar Loss Positions

Second dollar loss enhancements that qualify for the ratings-based multi-level approach, whether provided as recourse or direct credit substitutes, would be assessed risk-based capital only against the amount of the enhancement, and not against the more senior portions of the pool. This would continue the Banking Agencies' current risk-based capital treatment of direct credit substitutes and would significantly reduce the amount of capital that is currently required for second dollar loss recourse positions. All qualifying second dollar loss enhancements, including subordinated mortgage-backed securities, would be assigned to the 100% risk-weight category. This would continue the Banking Agencies' current treatment of purchased subordinated positions.

To qualify for treatment as a second dollar loss enhancement under the ratings-based multi-level approach, two requirements must be satisfied:[35]

- The securitization transaction itself would have to qualify for this approach (*i.e.*, it would involve a large, well diversified pool of assets and all forms of first dollar loss enhancement would be limited to the four types that are described above), and
- The enhancement would have to meet specified minimum credit rating requirements, as explained below.

For second dollar loss enhancements in the form of middle level or subordinated interests or securities, the interest or security would need a formal credit rating of at least investment grade from a nationally recognized statistical rating organization. The rating would be acceptable only if the same rating organization also provided the credit rating for each rated portion or security of the securitization. Risk-based capital would be assessed against qualifying middle level or subordinated interests or securities at the 100% risk-weight, based on the carrying value of the interest or security. No additional risk-based capital would be required for these qualifying interests or securities to support the more senior interests in the pool. *See* Example 1.

For second dollar loss enhancements in the form of financial standby letters of credit or other guarantee-type arrangements, the Agencies are considering two alternatives. One alternative would require that the portion of the underlying asset pool covered by the standby letter of credit must receive a formal credit rating of at least investment grade from a nationally recognized statistical rating organization. See Example 2A. The second alternative would require that the entire asset pool receive a formal credit rating of investment grade prior to the addition of the standby letter of credit.[36] See Example 2B.

(Question 7) The Agencies request comment on which of these alternatives would be more appropriate for purposes of applying the ratings-based multi-level approach.

(Question 8) The Agencies request comment on whether the above-described credit rating requirement for second dollar loss enhancements should be established at a higher level than investment grade. In particular, the Agencies seek information on the extent to which banking organizations and thrifts currently purchase subordinated interests (including middle level subordinated interests) and on the typical credit ratings for such purchased subordinated interests.

(Question 9) The Agencies request comment on how application of the ratings-based multi-level approach to second dollar loss enhancements would affect banking organizations or thrifts that provide financial standby letters of credit for asset-backed commercial paper programs and other asset securitizations.

A second dollar loss enhancement could qualify for this treatment even if it were not free of third-party performance risk. For example, a financial standby letter of credit, which has third party performance risk, could qualify for this preferential capital treatment if it had qualifying first-loss protection. That is, even though a financial standby letter of credit would not be considered to qualify for first loss protection for purposes of determining the capital requirement of more senior loss positions, the standby letter of credit itself could qualify for the treatment described above. Risk-based capital would be assessed at the 100% risk-weight against the face amount of the standby letter of credit.

It is possible that an asset securitization involving a large, well-diversified asset pool might satisfy the above credit rating requirements simply on the basis of asset quality, without the addition of any credit enhancement. In this circumstance, the risk of loss associated with providing credit enhancement for investment grade assets should be the same, regardless of whether the investment grade rating is based solely on asset quality or on some combination of asset quality plus first dollar loss credit enhancement. Therefore, the Agencies are considering whether to treat "first dollar loss" enhancements that provide credit support to pools or portions of pools (depending on which alternative is selected, as explained above) that have a formal credit rating of at least investment grade rating on a stand-alone basis in the same manner that qualifying second dollar loss enhancements would be treated under the ratings-based multi-level approach. See Example 3.

(Question 10) The Agencies request comment on this possible treatment of "first dollar loss" enhancements of investment grade assets.

Second dollar loss credit enhancements that are rated below investment grade or do not meet the other criteria stated above would not qualify for reduced capital requirements under the ratings-based multi-level approach.[37] The Agencies are considering requiring risk-based capital for such second dollar loss enhancements based on the amount of the enhancement plus all more senior positions, up to the lower of the size of the enhancement or the full risk-based capital requirement. (The provider of the second dollar loss enhancement would not be required to hold risk-based capital against the portion of the asset pool that is covered by the first dollar loss enhancement.)

The Agencies are concerned that assigning a single capital treatment to all second dollar loss positions rated below investment grade may not

[35] The Agencies intend that any position in a securitization that meets these requirements would qualify for treatment as a "second dollar loss enhancement" under the ratings-based multi-level approach.

[36] The credit ratings required under both alternatives are not the same as the credit rating that would be obtained for purposes of marketing the senior investment portions of the pool, which would represent an evaluation of the credit quality of the top portion of the asset pool, after the second dollar loss enhancement (and any other enhancement) is added.

[37] Because banks and thrifts are generally restricted from purchasing corporate debt securities rated below investment grade, this discussion primarily applies to second dollar loss positions, such as financial standby letters of credit, that are not in the form of subordinated securities.

adequately reflect the variation in credit risk of assets rated below investment grade.

(Question 11) The Agencies request comment on modifications to the capital requirement for second dollar loss enhancements rated below investment grade to better reflect different levels of credit risk.

In the event that the Agencies do not proceed with implementation of a multi-level approach, the Agencies would expect to propose amendments to the risk-based capital standards that would assess risk-based capital against all second dollar loss positions based on their face amounts plus the face amounts of all more senior outstanding positions (up to the maximum size of the second dollar loss position). For this reason the Agencies are particularly interested in receiving comment on all aspects of the ratings-based multi-level approach.

4. Risk-Based Capital Treatment of Senior Securities

Under the ratings-based multi-level approach, a senior security could qualify for a 20 percent risk weight, regardless of the risk-weight of the underlying assets, if:

- The securitization involves a large, well diversified pool of assets,
- All prior credit enhancement is limited to the permissible forms, and
- The security has received the highest possible rating from the same rating organization that provided the credit rating (if any) associated with the second dollar loss enhancement.

This preferential risk-based capital treatment for qualifying senior securities would apply regardless of whether a second dollar loss enhancement for the same transaction also qualifies for preferential treatment under the ratings-based multi-level approach. Senior securities that do not meet all of the specified conditions would be required to hold capital at the risk-weight appropriate to the pooled assets, in accordance with the current risk-based capital standards.

The term "senior security" would mean that no class of securities has a prior claim to payment from the underlying assets. Securities that do not have the first claim to payment would be treated as first or second dollar loss enhancements under the ratings-based multi-level approach (regardless of their credit rating).[38]

(Question 12) The Agencies request comment on whether a class of securities that receives the highest investment grade rating but is not the most senior class in a qualifying transaction should also be eligible for the 20% risk-weight category under the ratings-based multi-level approach.

(Question 13) The Agencies request comment on whether the ratings-based multi-level approach should be further adjusted to reflect the reduced risk of loss associated with positions rated above the minimum investment grade rating but below the highest investment grade rating.

The proposed favorable risk-based capital treatment of senior securities would be restricted to transactions in which all of the credit enhancement, including all second dollar loss credit enhancements, is either completely free of third-party performance risk or is provided internally through the securitization structure. Thus, to be eligible for the reduced risk-based capital assessment, a senior security would have to be supported solely by cash collateral accounts, subordinated interests (including middle level subordinated positions), spread accounts, or other forms of overcollateralization. If any part of the total credit enhancement provided is subject to third-party performance risk, then the senior portion of the issue would not be eligible for a reduced risk-based capital requirement under the ratings-based multi-level approach, regardless of its rating.[39] For example, if a financial standby letter of credit provides second dollar loss enhancement for an asset securitization, then the senior portion of that securitization would not be eligible for the 20% risk-weight. Risk-based capital would be held against the amount of the standby letter of credit and all portions of the transaction that are senior to the standby letter of credit in accordance with the current risk-based capital standards. See Example 4.

5. Maintenance of Minimum Ratings

The proposed favorable risk-based capital treatments for second dollar loss enhancements and senior securities under the ratings-based multi-level approach would be contingent upon maintenance of the required minimum ratings. If second dollar loss enhancement is downgraded below investment grade, if the senior securities are downgraded below the highest possible rating, or if either rating is withdrawn by the rating organization that provided the initial ratings, then the capital requirement would be adjusted accordingly.[40]

6. Conclusion

The Agencies believe that this preliminary proposal for a ratings-based multi-level approach could eliminate or reduce many of the concerns with the current treatment of recourse and direct credit substitutes. This approach would:

- Incorporate the proposed low-level recourse rule, so that an institution's capital would never exceed the contractual maximum amount of its exposure;
- Equalize the treatment of recourse arrangements and direct credit substitutes that present equivalent risk of loss; and
- Add flexibility to the regulatory capital requirements for recourse arrangements and direct credit substitutes by taking into account the different degrees of credit risk associated with first dollar loss and second dollar loss credit enhancements and senior positions for those asset securitizations where formal credit ratings are provided for the various positions.

The use of credit ratings would provide a way for the Agencies to use market determinations of credit quality to identify different loss positions for capital purposes in an asset securitization structure. The use of ratings could also enable the approach to be applied to large, well diversified pools of non-homogeneous assets, such as small business loans, because the market would determine the level of credit support necessary to obtain the various credit ratings. This may permit the Agencies to give more equitable treatment to a wide variety of transactions and structures in administering the risk-based capital system.

The flexibility of such a system would be particularly apparent in transactions that use overcollateralization to provide first dollar loss credit enhancement because the amount of the excess collateral will vary based on factors such as the quality of the underlying assets. One pool of assets may require 5% overcollateralization and another may require 20% overcollateralization to raise the credit quality of the pools to

[38] Senior securities that are not paid out until after another class or classes of securities from the same issue is completely paid out would be considered "senior securities" for purposes of the ratings-based multi-level approach, provided that they do not provide credit enhancement for another class of securities and that losses are shared on a pro rata basis in the event of default.

[39] The OTS would continue to apply the 20% risk-weight to any SMMEA security regardless of the type of credit enhancement provided in the transaction.

[40] The incorporation of the ratings-based multi-level approach into the risk-based capital standards would also not affect the Agencies' authority to require banking organizations and thrifts to hold additional capital beyond the minimum regulatory requirements, when warranted.

the investment grade level. Even though the second pool in this example has a greater amount of overcollateralization, the provider of second dollar loss enhancement for this transaction would not necessarily be in a safer loss position than the provider of second dollar loss enhancement for the pool that required only 5% overcollateralization. The use of credit ratings to determine the amount of first dollar loss protection could provide the Agencies with an inherently flexible method for identifying when an adequate first dollar loss position has been reached and when the second dollar loss position begins.

(Question 14) While the agencies believe that a ratings-based multi-level approach may be less costly for banking organizations and thrifts than a multi-level approach that depends more heavily on quantitative and qualitative analysis of individual securitizations and the positions within them, the agencies request comment on the costs of obtaining and monitoring ratings over time and on how these costs might compare with the cost of having to examine each position for purposes of determining its risk-based capital requirement.

B. Multi-Level Approach for Unrated Securitizations

The ratings-based multi-level approach relies on credit ratings to permit reduced risk-based capital requirements for qualifying credit enhancements and senior securities in certain asset securitizations. However, not all asset securitizations are rated and, in some securitizations, certain portions may be rated while others may be unrated. The Agencies recognize that there could be a need for a separate multi-level approach to establish capital requirements for unrated securitizations and unrated portions of rated securitizations. In theory, there are several ways to proceed.

The ideal multi-level approach for unrated securitizations would set capital requirements roughly equivalent to those for rated securitizations. To determine whether the credit quality of an unrated credit enhancement or security is similar to a rated credit enhancement or security, banking organizations and thrifts would need to: (1) Know the current loss position of the credit enhancement or security being evaluated, and (2) have current information on the credit quality of the underlying assets. This information could then be used in conjunction with a formula that relates the capital requirement for a credit enhancement or security to its loss position and the credit quality of the underlying assets.

Alternatively, the Agencies could develop a multi-level approach for unrated securitizations that assigns capital requirements based purely on a quantitative measure of sequential loss exposure (that is, the amount of loss protection provided by more junior positions), without regard to underlying asset quality. A refinement in this approach would be to develop quantitative measures for each asset type to reflect each type's default characteristics.

These alternatives represent two of the possible ways to establish a multi-level approach for unrated securitizations. The Agencies request comment on these and any other options.

If the Agencies do not proceed with a multi-level approach for unrated securitizations, they expect to extend the current risk-based capital treatment of recourse transactions to all unrated credit enhancements (*i.e.*, capital would be required against the face amount of the credit enhancement plus all more senior positions).

The Agencies request comment on the following questions:

(Question 15) Is there a need for a multi-level approach for unrated securitizations and unrated portions of rated securitizations?

(Question 16) Should the credit quality of the underlying loans be given additional consideration (beyond that present in the current risk-based capital requirements) in the capital requirements for unrated transactions? If so, how would this be accomplished? What other information, if any, should be considered in determining the capital requirements?

(Question 17) Should the loss position of the credit enhancement or security be taken into account in determining capital requirements for unrated transactions? If so, how would the loss position be determined? In particular, how should forms of prior enhancement such as overcollateralization and spread accounts be treated?

(Question 18) If the Agencies were to develop a multi-level approach that incorporates both qualitative and quantitative elements (the first alternative presented above), what problems might banking organizations and thrifts encounter in obtaining and maintaining the necessary information on loss positions and credit quality? How could the Agencies ensure consistent use of this information in determining loss positions and assigning capital requirements?

(Question 19) If the Agencies were to develop a multi-level approach based solely on quantitative measurement of loss positions (the second alternative presented above), how should such an approach be designed?

(Question 20) How might a multi level approach be designed so that positions that would not, if rated, qualify for reduced capital requirements under the ratings-based approach, also would not qualify for reduced capital requirements under the multi-level approach for unrated transactions?

(Question 21) How can a multi-level approach for unrated securitizations be designed so it does not create an unreasonable bias toward or away from obtaining ratings?

IV. Application of Any Final Rules

The Agencies intend that any final rules adopted in connection with this notice of proposed rulemaking and advance notice of proposed rulemaking that result in increased risk-based capital requirements for banking organizations or thrifts would apply only to transactions that are consummated after the effective date of such final rules. The Agencies intend that any final rules adopted in connection with this notice that result in reduced risk-based capital requirements for banking organizations or thrifts would apply to all transactions outstanding as of the effective date of such final rules and to all subsequent transactions.

V. Sample Applications of the Ratings-Based Multi-Level Approach

Example 1A—Senior/Subordinated Structure

Bank A issues three classes of securities that are backed by a $212 million, well-diversified pool of residential mortgage loans that individually qualify for the 50% risk-weight category—a bottom-level subordinated class of $12 million, a middle-level subordinated class of $20 million and a senior class of $180 million. Bank A retains the bottom-level class and sells the other two classes to banking organizations or thrifts.

Bank A, retaining the bottom-level subordinated class, would be required to hold risk-based capital equal to 4% of the $212 million pool (*i.e.*, the full effective risk-based capital requirement for the outstanding amount of the assets enhanced). Because this subordinated class provides sufficient first dollar loss enhancement, a nationally recognized statistical rating organization gives the $20 million middle class an investment grade rating. Since this class is rated

investment grade, risk-based capital would be held against it at the 100% risk-weight, based solely on its carrying value. That is, the holder of the middle-level class would not be required to hold any capital against the senior class it supports. The same rating organization gives its highest credit rating to the $180 million senior class. Since this is the most senior class, has the highest possible credit rating, and all prior enhancements are performance risk-free, risk-based capital would be calculated at the 20% risk-weight. Table 1 summarizes this example.

TABLE 1.—SENIOR-SUBORDINATED STRUCTURE

[Underlying Assets—Type: Residential Mortgage Loans; Amount: $212 million]

Loss position	Size ($ mill)	Credit rating	Current treatment for thrifts ($ mill)	Current treatment for banks [1] ($ mill)	Ratings proposal ($ mill)
1st	$12	No IG rating	$8.48	$8.48	$8.48
2nd	20	IG	8.00	1.60	1.60
3rd	180	Highest IG rating	2.88	7.20	2.88
TOTAL CAPITAL: In Dollars			19.36	17.28	12.96
As Percent Of Pool			9.1%	8.2%	6.1%

IG=Investment Grade

[1] Under the Banking Agencies' existing capital rules the capital charges for retained first and second loss positions differ from the capital requirements for purchased first and second loss positions. For example, a bank must hold regulatory capital equal to 8 percent of the carrying value of a purchased subordinated position at the 100% risk-weight, whereas a retained subordinated position is subject to a capital requirement against the full value of all the assets enhanced. (In contrast, the OTS treats both of these positions in the same way, requiring capital against the full value of the assets enhanced.) The proposed new rules would eliminate such disparate capital treatment by focusing the capital charge on the risk of recourse arrangements or credit substitutes, rather than the manner in which they are acquired. Note, however, that other rules restricting banks from purchasing or holding securities that are of less than investment grade quality already limit the opportunities to exploit the disparities present in existing capital rules.

Example 1B—A First Loss Position That Qualifies for the Low-Level Recourse Rule

Bank A issues three classes of securities that are backed by a $212 million, well-diversified pool of consumer loans that individually qualify for the 100% risk-weight category—a bottom-level subordinated class of $12 million, a middle-level subordinated class of $20 million and a senior class of $180 million. Bank A retains the bottom-level class and sells the other two classes to banking organizations or thrifts.

Without the proposed low-level recourse rule, Bank A's capital requirement for the $12 million bottom-level subordinated class would be $16.96 million, *i.e.*, a full risk-based capital requirement of 8% against the $212 million mortgage pool enhanced by this class. The low-level recourse rule, however, would allow the risk-based capital requirement to fall below the full effective capital requirement when the recourse obligation falls below the full effective capital requirement. Thus, the capital requirement would be the lesser of either the maximum contractual recourse obligation or the full effective capital requirement. Consequently, the bottom-level class in this example would be assessed dollar-for-dollar capital up to its $12 million carrying value, for a capital requirement of $12 million.

Because the bottom-level subordinated class provides sufficient first dollar loss enhancement, a nationally recognized statistical rating organization gives the $20 million middle class an investment grade rating. Since this class is rated investment grade, risk-based capital would be assessed against it at the 100% risk-weight, based solely on its carrying value. That is, the holder of the middle-level class would not be assessed any capital against the senior class it supports. The same rating organization gives its highest credit rating to the $180 million senior class. Since this is the most senior class, has the highest possible credit rating, and all prior enhancements are performance risk-free, risk-based capital would be assessed against this class at the 20% risk-weight. Table 2 summarizes this example.

TABLE 2.—AN APPLICATION OF THE LOW-LEVEL RECOURSE RULE

[Underlying Assets—Type: Consumer Loans; Amount: $212 million]

Loss position	Size ($ mill)	Credit rating	Current treatment for thrifts [1] ($ mill)	Current Treatment for Banks [2] ($ mill)	Ratings proposal ($ mill)
1st	$12	No IG rating	$12.00	$16.96	$12.00
2nd	20	IG	16.00	1.60	1.60
3rd	180	Highest IG rating	14.40	14.40	2.88
TOTAL CAPITAL: In Dollars			42.40	32.96	16.48
As Percent Of Pool			20.0%	15.6%	7.8%

IG=Investment Grade

[1] OTS already has a low-level recourse rule in place for thrifts.

[2] See note 1 to Table 1.

Example 2A—Investment Grade Rating Applied to Portion of Pool Covered by Standby Letter of Credit

The XYZ Company is seeking the highest possible credit rating on an asset-backed commercial paper issuance that is backed by a large, well-diversified pool of trade receivables. A total of $200 million of commercial paper is issued against the pool, which contains $212 million worth of trade receivables. Thus, there is $12 million of overcollateralization available to provide loss protection.

To obtain the highest rating for the commercial paper, the XYZ Company also purchases a standby letter of credit from Bank B that covers the next $20 million of losses after the $12 million of overcollateralization. This letter of credit provides loss protection analogous to the middle-level subordinated class of securities in Examples 1A and 1B above. A nationally recognized statistical rating organization provides a formal credit rating of investment grade for the position, i.e., that portion of pool losses that represents the exposure to be covered by the $20 million letter of credit. As a result, under the Agencies' first alternative for application of the ratings-based multi-level approach to this type of transaction, risk-based capital would be assessed against the $20 million standby letter of credit at the 100% risk-weight, based on its credit equivalent amount. That is, Bank B would not be required to hold capital against the additional $180 million supported by the standby letter of credit. If the rating given to the letter of credit was not at least investment grade, then Bank B would be required to hold capital at the 100% risk-weight against the credit equivalent amount of its letter of credit and all senior classes that it supports (in this case, against $200 million).

Example 2B—Investment Grade Rating Applied to the Entire Pool of Assets

The details of the transaction here are identical to those of example 2A, except that the investment grade rating provided by a nationally recognized statistical rating organization is not on the second loss position, but on the entire $212 million pool, *prior* to the addition of Bank B's standby letter of credit. As a result, under the Agencies' second alternative for application of the ratings-based multi-level approach to this type of transaction, risk-based capital would be assessed against the $20 million standby letter of credit at the 100% risk-weight, based on its credit equivalent amount. That is, Bank B would not be required to hold capital against the $180 million of the pool that the standby letter of credit supports, but does not cover. If the rating given to the entire pool prior to the addition of the letter of credit were not at least investment grade, then Bank B would be required to hold capital at the 100% risk-weight against the credit equivalent amount of its letter of credit and all the senior classes that it supports (in this case, against $200 million).

Example 3—Investment Grade Rating on First Loss Position

If the Agencies adopt the proposed alternative to treat certain "first dollar loss" enhancements that have a formal credit rating of at least investment grade in the same manner as qualifying second dollar loss enhancements, the following example would apply:

Bank C issues two classes of securities that are backed by a $212 million, well-diversified pool of auto loans—a subordinated class of $12 million and a senior class of $200 million. Bank C retains the bottom-level class and sells the other class to either a banking organization or thrift.

Because of the high credit quality of the underlying loans, a nationally-recognized statistical rating organization gives the $212 million pool of auto loans a rating equal to one level above investment grade on a stand-alone basis The $12 million subordinated class is given an investment grade rating. Since this class is rated investment grade, risk-based capital would be assessed against it at the 100 percent risk-weight, based solely on its carrying value. That is, Bank C would not be assessed any capital against the senior class it supports. On the basis of the high credit quality of the underlying loans, and the loss protection provided by the subordinated class, the same rating organization gives its highest credit rating to the $200 million senior class. Since this is the most senior class, has the highest possible credit rating, and all prior enhancements are performance risk-free, risk-based capital would be assessed against this class at the 20 percent risk-weight. Table 3 summarizes this example.

TABLE 3.—INVESTMENT GRADE RATING ON THE FIRST LOSS POSITION

[Underlying Assets—Type: Auto Loans; Amount: $212 million]

Loss position	Size ($ mill)	Credit rating	Current treatment for thrifts ($ mill)	Current treatment for banks [1] ($ mill)	Ratings proposal ($ mill)
1st	$12	IG	$12.00	$16.96	$0.96
2nd	200	Highest IG rating	16.00	16.00	3.20
TOTAL CAPITAL: In Dollars			28.00	32.96	4.16
As Percent Of Pool			13.2%	15.6%	2.0%

IG = Investment Grade
[1] See note 1 to Table 1.

Example 4—Nonqualifying Senior Position

Bank D issues two classes of securities backed by a $212 million, well-diversified pool of consumer loans—a subordinated class of $12 million, which would be rated below investment grade, and a senior class of $200 million. Bank D retains the bottom-level class and sells the other class to a banking organization or thrift. In the absence of additional credit enhancements, a nationally recognized statistical rating organization will rate the senior class one grade below its highest credit rating as a result of the first dollar loss enhancement from the subordinated class.

Bank D obtains a letter of credit to provide additional enhancement to the transaction from a company whose obligations have the highest possible credit rating from the same credit rating organization. The credit rating organization now gives its highest possible credit rating to the senior class in this transaction. However, since this credit rating is a result of a prior enhancement that is provided in the form of a standby letter of credit, which

has performance risk, risk-based capital would be assessed against the senior class at the 100% risk-weight rather than at the 20% risk-weight. Under the ratings-based multi-level approach, the 20% risk-weight would only be applied to qualifying senior interests that are supported by prior credit enhancements that are in the form of overcollateralization, spread accounts, cash collateral accounts, or subordinated interests. Table 4 summarizes this example.

TABLE 4.—NON-QUALIFYING SENIOR POSITION

[Underlying Assets—Type: Consumer Loans; Amount: $212 million]

Loss position	Size ($ mill)	Credit rating	Current treatment for thrifts ($ mill)	Current treatment for banks [1] ($ mill)	Ratings proposal ($ mill)
1st	$12	No IG rating	$12.00	$16.96	$12.00
2nd	200	Highest IG rating [2]	16.00	16.00	16.00
TOTAL CAPITAL: In Dollars			28.00	32.96	28.00
As Percent Of Pool			13.2%	15.6%	13.2%

IG = Investment Grade

[1] See note 1 to Table 1.

[2] Highest credit rating achieved because of a standby letter of credit issued on the senior class by a company whose obligations have the highest credit rating.

VI. Additional Issues for Comment

The Agencies request comment on all aspects of the proposed amendments to the risk-based capital treatment of recourse and direct credit substitutes and on all aspects of the proposal to adopt a multi-level approach. In addition to the questions set out above, the agencies request comment on the following:

A. Proposal

1. Definitions of Recourse and Direct Credit Substitutes

(Question 22) Does the proposed definition of the term "standard representations and warranties" provide a workable definition for determining whether a representation or warranty will be considered recourse or a direct credit substitute?

(Question 23) Does the proposed definition of a "servicer cash advance" provide a workable definition for determining whether a cash advance will be considered recourse or a direct credit substitute?

2. Low-Level Recourse Rule

(Question 24) Would the low-level recourse rule lower transaction costs or otherwise help facilitate the sale or securitization of banking organization assets?

3. Treatment of Direct Credit Substitutes

(Question 25) For banking organizations and thrifts in general, or for your particular institution, please answer the following questions:

(a) For securitized or pooled transactions, and separately for non-securitized transactions, approximately what portion of third-party financial standby letters of credit provides less than 100% loss protection for the underlying assets? What are the typical circumstances of such arrangements?

(b) For securitized or pooled transactions, and separately for non-securitized transactions, do financial standby letters of credit typically absorb the first dollars of losses or the second dollars of losses from third-party assets, as defined in this section of the proposal? What is the approximate dollar amount of financial standby letters of credit provided by banking organizations and thrifts that absorb the first dollars of losses from third-party assets?

(c) What is the approximate dollar amount of purchased subordinated interests that absorb the first dollars of losses from third-party assets, as defined in this section of the proposal?

B. Advance Notice of Proposed Rulemaking—Ratings-Based Multi-Level Approach

(Question 26) Should the Agencies require that prior credit enhancements be free of performance risk in order for second dollar loss enhancements and senior positions to qualify for reduced risk-based capital requirements?

(Question 27) The discussion of the multi-level approach deals with varying the capital requirement in asset securitizations based on an institution's degree of exposure to credit risk. Does a multi-level approach have any applicability to sales or participations of individual, secured, unrated loans (including multifamily loans) with recourse under various loss sharing arrangements?

VII. Regulatory Flexibility Act

It is hereby certified that the proposed changes to the Agencies' risk-based capital standards will not have a significant economic impact on a substantial number of small entities, in accord with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). Most of the transactions that will be affected by the proposed changes are conducted by large banking organizations and large thrifts. In addition, consistent with current policy, the FRB's revised guidelines generally will not apply to bank holding companies with consolidated assets of less than $150 million. The intent of the proposal is to correct certain inconsistencies in the Agencies' risk-based capital standards and to allow banking organizations to maintain lower amounts of capital against low-level recourse obligations by adopting the current OTS capital treatment of those transactions. Accordingly, a Regulatory Flexibility Act Analysis is not required.

VIII. Executive Order 12866

OCC and OTS have determined that the proposed rule described in this notice is not a significant regulatory action under Executive Order 12866. Accordingly, a regulatory impact analysis is not required. The intent of the proposal is to correct certain inconsistencies in the Agencies' risk-based capital standards and to allow banking organizations to maintain lower amounts of capital against low-level recourse obligations by adopting the current OTS capital treatment of those transactions. Under the proposal, each institution's measured risk-based capital ratio may change. However, this change in measured capital ratios should have no material effect on the safety and soundness of the banking and thrift industries. Most banks and thrifts have capital ratios much in excess of minimum requirements. Of the 11,071

commercial banks in operation at the end of September 1993, 10,824 were well-capitalized (risk-based capital ratios in excess of 10 percent). For the thrift industry, as of June 30, 1993, 1,561 of 1,752 savings associations were similarly well-capitalized. Given the high level of capitalization in the industry, the net effect on the safety and soundness of the banking industry and the overall economy should be minimal.

IX. Paperwork Reduction Act

The following information about paperwork relates only to Federal Reserve (FR) reports, which are approved by the Federal Reserve Board under delegated authority from the Office of Management and Budget (OMB).

The proposed amendments to the Capital Adequacy Guidelines may require reporting revisions to the Consolidated Financial Statements for Bank Holding Companies With Total Consolidated Assets of $150 Million or More or With More Than One Subsidiary Bank (FR Y-9C; OMB No. 7100-0128). Any revisions will be determined by the Federal Reserve Board under delegated authority from OMB.

Description of Affected Report

Report Title: Consolidated Financial Statements for Bank Holding Companies With Total Consolidated Assets of $150 Million or More, or With More than One Subsidiary Bank.

This report is filed by all bank holding companies that have total consolidated assets of $150 million or more and by all multibank holding companies regardless of size. The following bank holding companies are exempt from filing the FR Y-9C, unless the FRB specifically requires an exempt company to file the report: bank holding companies that are subsidiaries of another bank holding company *and* have total consolidated assets of less than $1 billion; bank holding companies that have been granted a hardship exemption by the FRB under section 4(d) of the Bank Holding Company Act, 12 U.S.C. 1843(d); and foreign banking organizations as defined by section 211.23(b) of Regulation K.

List of Subjects

12 CFR Part 3

Administrative practice and procedure, Capital risk, National banks, Reporting and recordkeeping requirements.

12 CFR Part 208

Accounting, Agriculture, Banks, Banking, Branches, Capital adequacy, Confidential business information, Currency, Reporting and recordkeeping requirements, Securities, State member banks.

12 CFR Part 225

Administrative practice and procedure, Banks, Banking, Capital adequacy, Holding companies, Reporting and recordkeeping requirements, Securities.

12 CFR Part 325

Bank deposit insurance, Banks, Banking, Capital adequacy, Reporting and recordkeeping requirements, Savings associations, State nonmember banks.

12 CFR Part 567

Capital, Reporting and recordkeeping requirements, Savings associations.

DEPARTMENT OF THE TREASURY

COMPTROLLER OF THE CURRENCY

12 CFR Chapter I

Authority and Issuance

For the reasons set out in the preamble, part 3 of chapter I of title 12 of the Code of Federal Regulations is proposed to be amended as follows:

PART 3—MINIMUM CAPITAL RATIOS; ISSUANCE OF DIRECTIVES

1. The authority citation for part 3 continues to read as follows:

Authority: 12 U.S.C. 93a, 161, 1818, 1828(n), 1828 note, 1831n note, 3907 and 3909.

Appendix A [Amended]

2. In appendix A, section 1, paragraphs (c)(10) through (c)(29) are redesignated as follows:

Old paragraph	New paragraph
(c)(10)	(c)(11)
(c)(11)	(c)(13)
(c)(12)	(c)(14)
(c)(13)	(c)(15)
(c)(14)	(c)(16)
(c)(15)	(c)(17)
(c)(16)	(c)(18)
(c)(17)	(c)(19)
(c)(18)	(c)(21)
(c)(19)	(c)(22)
(c)(20)	(c)(23)
(c)(21)	(c)(25)
(c)(22)	(c)(26)
(c)(23)	(c)(27)
(c)(24)	(c)(30)
(c)(25)	(c)(31)
(c)(26)	(c)(32)
(c)(27)	(c)(33)
(c)(28)	(c)(34)
(c)(29)	(c)(35)

3. In appendix A, section 1, new paragraphs (c)(10), (12), (20), (24), (28) and (29) are added and paragraph (c)(22) is revised, to read as follows:

Appendix A to Part 3—Risk-Based Capital Guidelines

* * * * *

Section 1. Purpose, Applicability of Guidelines, and Definitions.

* * * * *

(c) * * *

(10) *Direct credit substitute* means the assumption, in form or in substance (other than through providing recourse), of any risk of loss directly or indirectly associated with an asset or other claim, that exceeds the national bank's pro rata share of the asset or claim. If a national bank has no claim on the asset, then the assumption of any risk of loss is a direct credit substitute. Direct credit substitutes include, but are not limited to:

(i) Financial guarantee-type standby letters of credit that support financial claims on the account party;

(ii) Guarantees and guarantee-type instruments backing financial claims;

(iii) Purchased subordinated interests or securities that absorb more than their pro rata share of losses from the underlying assets; and

(iv) Purchased loan servicing rights if the servicer is responsible for losses associated with the loans being serviced (other than servicer cash advances as defined in this section 1(c) of this appendix A), or if the servicer makes or assumes representations and warranties about the loans other than standard representations and warranties as defined in this section 1(c) of this appendix A).

* * * * *

(12) *Financial guarantee-type standby letter of credit* means any letter of credit or similar arrangement, however named or described, which represents an irrevocable obligation to the beneficiary on the part of the issuer (1) to repay money borrowed by or advanced to or for the account of the account party, or (2) to make payment on account of any indebtedness undertaken by the account party, in the event that the account party fails to fulfill its obligation to the beneficiary.

* * * * *

(20) *Performance-based standby letter of credit* means any letter of credit, or similar arrangement, however named or described, which represents an irrevocable obligation to the beneficiary on the part of the issuer to make payment on account of any default by the account party in the performance of a nonfinancial or commercial obligation.

* * * * *

(22) *Public-sector entities* includes states, local authorities and governmental subdivisions below the central government level in an OECD country. In the United States, this definition encompasses a state, county, city, town or other municipal corporation, a public authority, and generally any publicly-owned entity that is an instrumentality of a state or municipal corporation. This definition does not include

commercial companies owned by the public sector.

* * * * *

(24) *Recourse* means the retention, in form or substance, of any risk of loss directly or indirectly associated with a transferred asset that exceeds a pro rata share of a national bank's claim on the asset. If a national bank has no claim on a transferred asset, then the retention of any risk of loss is recourse. A recourse arrangement typically arises when an institution transfers assets and retains an obligation to repurchase the assets or absorb losses due to a default of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse arrangements include, but are not limited to:

(i) Representations and warranties about the transferred assets other than standard representations and warranties as defined in this section 1(c) of this appendix A;

(ii) Retained loan servicing rights if the servicer is responsible for losses associated with the loans being serviced (other than servicer cash advances as defined in this section 1(c) of this appendix A;

(iii) Retained subordinated interests or securities that absorb more than their pro rata share of losses from the underlying assets;

(iv) Assets sold under an agreement to repurchase; and

(v) Loan strips sold without direct recourse where the maturity of the participation is shorter than the maturity of the underlying loan.

* * * * *

(28) *Servicer cash advance* means funds that a loan servicer advances to ensure an uninterrupted flow of payments or the timely collection of loans, including disbursements made to cover foreclosure costs or other expenses arising from a loan to facilitate its timely collection. A servicer cash advance is not recourse or a direct credit substitute if the servicer is entitled to full reimbursement, or for any one loan, nonreimbursable amounts are contractually limited to an insignificant amount of the outstanding principal on that loan.

(29) *Standard representations and warranties* means contractual provisions that a national bank extends when it transfers assets (including loan servicing rights), or assumes when it purchases loan servicing rights, that refer to existing facts at the time the assets are transferred or servicing rights are acquired and that have been verified with reasonable due diligence by the transferor or servicer. Standard representations and warranties also include contractual provisions for the return of assets in the event of fraud or documentation deficiencies. Standard representations and warranties do not constitute recourse or direct credit substitutes.

* * * * *

Appendix A [Amended]

4. In appendix A, section 3, a new paragraph is added after the second paragraph of the introductory text and prior to paragraph (a), paragraphs (b)(1)(i) and (ii) are revised, paragraph (b)(1)(iii) is removed and reserved, a new paragraph (c) is added, and footnotes 16, 17, and 18 are revised, to read as follows:

* * * * *

Section 3. Risk Categories/Weights for On-Balance Sheet Assets and Off-Balance Sheet Items

* * * * *

Assets transferred with recourse are treated in accordance with section 3(c) of this appendix A.

* * * * *

(b) * * *

(1) * * * (i) Recourse arrangements and direct credit substitutes,[13] in accordance with section 3(c) of this appendix A.[14]

(ii) Risk participations purchased in bankers acceptances.

(iii) [Reserved]

* * * * *

(2) * * *

(i) * * * [16] * * *

(ii) * * * [17] * * *

* * * * *

(4) * * *

(ii) * * * [18] * * *

(c) *Recourse arrangements and direct credit substitutes*—(1) *Risk-weighted asset amount—on-balance sheet assets.* To calculate the risk-weighted asset amount for a recourse arrangement that is an on-balance sheet asset, multiply the amount of assets from which risk of loss is directly or indirectly retained by the appropriate risk weight using the criteria regarding obligors, guarantors, and collateral listed in section 3(a) of this appendix A.

(2) *Risk-weighted asset amount—off-balance sheet items.* To calculate the risk-weighted asset amount for a recourse arrangement or direct credit substitute that is not an on-balance sheet asset, multiply the on-balance sheet credit equivalent amount by the appropriate risk weight using the criteria regarding obligors, guarantors, and collateral listed in section 3(a) of this appendix A.

(3) *On-balance sheet credit equivalent amount.* Except as otherwise provided by this paragraph, the on-balance sheet credit equivalent amount for a recourse arrangement or direct credit substitute is the amount of assets from which risk of loss is directly or indirectly retained or assumed. For purposes of this section 3(c) of this appendix A, the amount of assets from which risk of loss is directly or indirectly retained or assumed means:

(i) For a financial guarantee-type standby letter of credit, guarantee, or other guarantee-type arrangement, the assets that the direct credit substitute fully or partially supports;

(ii) For a subordinated interest or security, the amount of the subordinated interest or security plus all more senior interests or securities;

(iii) For mortgage servicing rights that are recourse arrangements or direct credit substitutes, the outstanding amount of the loans serviced;

(iv) For representations and warranties (other than standard representations and warranties), the amount of the loans subject to the representations or warranties; and

(v) For loans strips that are recourse arrangements or direct credit substitutes, the amount of the loans.

(4) *Second-loss position direct credit substitutes.* The on-balance sheet credit equivalent amount for a direct credit substitute is the face amount of the direct credit substitute if:

(i) There is a prior credit enhancement that absorbs the first dollars of loss from the underlying assets that the direct credit substitute fully or partially supports; and

(ii) The direct credit substitute is either:

(A) A financial guarantee-type standby letter of credit, guarantee or other guarantee-type arrangement that absorbs the second dollars of loss from the underlying assets; or

(B) A purchased subordinated interest or security that absorbs the second dollars of loss from the underlying assets.

(5) *Participations.* The on-balance sheet credit equivalent amount for a participation interest in a standby letter of credit, guarantee, or other guarantee-type arrangement is calculated as follows:

(i) Determine the on-balance sheet credit equivalent amount as if the bank held all of the interests in the participation.

(ii) Multiply the on-balance sheet credit equivalent amount determined under section 3(c)(5)(i) of this appendix A by the percentage of the bank's participation interest.

(iii) If the bank is exposed to more than its pro rata share of the risk of loss on the direct credit substitute (*e.g.*, the bank remains secondarily liable on participations held by others), add to the amount computed under section 3(c)(5)(ii) of this appendix A an amount computed as follows: multiply the amount computed under 3(c)(5)(i) by the percentage of the direct credit substitute held by others and then multiply the result by the risk-weight appropriate for the holders of those interests. (Note that this risk-weighting is in addition to the risk-weighting done to convert the on-balance sheet credit

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[13] [Reserved]

[14] Mortgage loans sold in transactions in which the bank retains only an insignificant amount of risk and makes concurrent provision for that risk are not considered assets sold with recourse under section 3. In order to qualify for sales treatment, such transactions must meet three conditions: (1) The bank has not retained any significant risk of loss, either directly or indirectly; (2) The bank's 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 equal to or less than the amount of probable loss that the bank has reasonably estimated that it will incur on the transferred mortgages; and (3) The bank must have created a liability account or other special reserve in an amount equal to its maximum exposure. The amount of this liability account or other special reserve may not be included in capital for the purpose of determining compliance with either the risk-based capital requirement or the leverage ratio; nor may it be included in the allowance for loan and lease losses.

[16] Participations in performance-based standby letters of credit are treated in accordance with section 3(c) of this appendix A.

[17] Participations in commitments are treated in accordance with section 3(c) of this appendix A.

[18] See definition of "unconditionally cancelable" in section 1(c) of this appendix A.

equivalent amount to the risk-weighted asset amount under section 3(c)(2) of this appendix A.)

(6) *Limitations on risk-based capital requirements*—(i) *Low-level exposure.* If the maximum contractual liability or exposure to loss retained or assumed by a bank in connection with a recourse arrangement or a direct credit substitute is less than the risk-based capital required to support the recourse obligation or direct credit substitute, the risk-based capital requirement is limited to the maximum contractual liability or exposure to loss.

(ii) *Mortgage-related securities or participation certificates retained in a mortgage loan swap.* If a bank holds a mortgage-related security or a participation certificate as a result of a mortgage loan swap with recourse, capital is required to support the recourse obligation and that percentage of the mortgage-related security or participation certificate that is not covered by the recourse obligation. The total amount of capital required for the on-balance sheet asset and the recourse obligation, however, is limited to the capital requirement for the underlying loans, calculated as if the bank continued to hold these loans as an on-balance sheet asset.

* * * * *

Appendix A [Amended]

4. In appendix A, Table 2, paragraph 1 under "100 Percent Conversion Factor" is revised to read as follows:

Table 2—Credit Conversion Factors for Off-Balance Sheet Items

100 Percent Conversion Factor

1. Direct credit substitutes (arrangements to assume risk of loss from assets other than through providing recourse, including purchased subordinated interests and general guarantees of indebtedness and guarantee-type instruments, such as standby letters of credit serving as financial guarantees for, or supporting, loans and securities).

* * * * *

FEDERAL RESERVE SYSTEM

12 CFR Chapter II

Authority and Issuance

For the reasons set out in the preamble, parts 208 and 225 of chapter II of title 12 of the Code of Federal Regulations are proposed to be amended as follows:

PART 208—MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM (REGULATION H)

1. The authority citation for part 208 is revised to read as follows:

Authority: 12 U.S.C. 248(a) and 248(c), 321–328, 461, 481–486, 601, 611, 1814, 1818, 1823(j), and 1831o.

2. Section III of appendix A to part 208 is amended by adding a new paragraph B.5, and by revising the introductory text to paragraph D and paragraph D.1 to read as follows:

Appendix A to Part 208—Capital Adequacy Guidelines For State Member Banks: Risk-Based Measure

* * * * *

III. Procedures for Computing Weighted Risk Assets and Off-Balance Sheet Items

* * * * *

B. * * *

5. *Recourse arrangements and direct credit substitutes.* Banks may engage in activities—such as securitizing pools of assets, selling single assets, and entering into certain off-balance sheet transactions—that result in the provision of a credit enhancement in the form of a recourse arrangement or a direct credit substitute. The risk-based capital treatment of recourse arrangements and direct credit substitutes is discussed in section III.D of this appendix A. The following definitions of the terms "recourse" and "direct credit substitute" apply for risk-based capital purposes.

Recourse is the retention, in form or in substance, of any risk of loss directly or indirectly associated with an asset a bank has transferred that is in excess of the bank's *pro rata* share of the asset. A recourse arrangement typically arises when an institution transfers an asset and retains an obligation to repurchase the asset or to absorb losses on the asset arising from a default of principal or interest or any other deficiencies in the performance of the underlying obligor or some other party.

A direct credit substitute is the assumption, in form or substance through a nonrecourse arrangement, of any risk of loss directly or indirectly associated with an asset or other claim in excess of the bank's *pro rata* share of the asset or other claim. A direct credit substitute arrangement typically arises when an institution issues a standby letter of credit, purchases a subordinated security that provides loss protection to more senior securities, or purchases servicing rights, such as mortgage servicing rights, that obligate the servicer to provide credit protection to the third-party owners of the assets being serviced.

For most direct credit substitutes, the amount of the bank's exposure to be converted to an on-balance sheet credit equivalent typically is the full face value of the item. However, for direct credit substitutes, such as purchased subordinated securities that are carried on the balance sheet and directly or indirectly absorb the first losses from a third-party asset, pool of assets, or other claim, the full amount of the bank's off-balance sheet exposure that is to be converted is the entire outstanding principal amount of the asset, pool of assets, or other claim, less the amount of the on-balance sheet direct credit substitute against which capital is already held. This treatment applies regardless of whether the direct credit substitute fully or partially supports the asset, pool of assets, or other claim. The full amount of the bank's off-balance sheet exposure to be converted may be the same or greater than the face value of the direct credit substitute. For instance, in the case of purchased subordinated securities that absorb first losses, the entire outstanding principal amount of all more senior securities that are supported by that subordinated interest (to the extent they are not already reported on the bank's balance sheet) are converted to an on-balance sheet credit-equivalent amount.

For risk-based capital purposes, non-standard representations or warranties a bank may extend in transferring assets (including the transfer of servicing rights), or may assume in other transactions, including the acquisition of loan servicing rights, are treated as recourse or direct credit substitutes.[24a] Standard representations and warranties, which normally do not constitute recourse or direct credit substitutes for risk-based capital purposes, are contractual provisions referring to an existing set of facts that has been verified with reasonable due diligence by the seller or servicer at the time the assets are transferred or loan servicing rights are acquired. Standard representations and warranties also include contractual provisions that provide for the return of the assets to the seller in instances of fraud or upon determination by the purchaser that the assets transferred are not fully and properly documented or otherwise as represented by the seller.

A cash advance by a loan servicer does not constitute recourse or a direct credit substitute if the servicer is entitled to full reimbursement, or for any one loan, nonreimbursable amounts are contractually limited to an insignificant amount of the outstanding principal on that loan. A servicer cash advance is an arrangement under which the servicer advances funds to ensure an uninterrupted flow of payments to investors or the timely collection of loans. Funds advanced to ensure the timely collection of loans include disbursements made to cover foreclosure costs or other expenses incurred to facilitate the timely collection of a loan.

* * * * *

D. * * *

Before an off-balance sheet item can be incorporated into the risk-based capital ratio, the on-balance sheet credit-equivalent amount of the item must be determined. Once the credit-equivalent amount is determined, the amount is then assigned to the appropriate risk category according to the obligor, or if relevant, the guarantor or the nature of the collateral.[40] The method for determining the credit-equivalent amount of an interest-rate or exchange-rate contract is

[24a] *Representations* are statements, express or implied, regarding a past or existing fact, circumstance, or state of facts pertinent to the contract, which is influential in bringing about the agreement. *Warranties* are promises that certain facts are truly as they are represented to be and that they will remain so, subject to specified limitations.

[40] The sufficiency of collateral and guarantees for off-balance sheet items is determined by the market value of the collateral or the amount of the guarantee in relation to the face amount of the item, except for interest- and exchange-rate contracts, for which this determination is made in relation to the credit-equivalent amount. Collateral and guarantees are subject to the same provisions noted under section III.B of this appendix A.

set forth in section III.E.2 of this appendix A. For most other types of off-balance sheet items, the on-balance sheet credit-equivalent amount is determined by multiplying the full amount of the bank's exposure under the item by the applicable credit conversion factor as set forth below and in Attachment IV to this appendix A.

However, in the case of direct credit substitutes—which are described in detail in section III.B.5 of this appendix A and section III.D.1 of this appendix A—that directly or indirectly absorb the first losses from an asset, pool of assets, or other claim, the full amount of a bank's exposure that is to be converted is the entire outstanding principal amount of the asset, pool of assets, or other claim, less the amount of any on-balance sheet exposure associated with the item against which capital is already held. This treatment applies regardless of whether the direct credit substitute fully or partially supports the asset, pool of assets, or other claim. The full amount of the bank's exposure to be converted may be the same or greater than the face value of the direct credit substitute. For instance, in the case of standby letters of credit that absorb first losses, the entire outstanding principal amount of a customer's loan or debt instrument that is supported by the letter of credit is converted to an on-balance sheet credit-equivalent amount.

Generally, the full face value of an off-balance sheet item is converted to an on-balance sheet credit-equivalent amount and incorporated in weighted risk assets and, thus, is subject to a full effective risk-based capital requirement. However, the aggregate capital requirement on a first loss direct credit substitute or a recourse transaction (including a transaction reported as a financing on a bank's balance sheet) is limited to the maximum contractual amount of loss to which the direct credit substitute or recourse arrangement exposes the institution if this amount is less than the effective risk-based capital charge for the asset, pool of assets, or other claim supported by the direct credit substitutes or recourse arrangement.

1. *Items with a 100 percent conversion factor.* A 100 percent conversion factor applies to direct credit substitutes, which include guarantees, or equivalent instruments, backing financial claims such as outstanding securities, loans, and other financial liabilities, or that back off-balance sheet items that require capital under the risk-based capital framework. Direct credit substitutes include, for example, financial standby letters of credit, or other equivalent irrevocable undertakings or surety arrangements, that guarantee repayment of financial obligations such as: commercial paper, tax-exempt securities, commercial or individual loans or debt obligations, or standby or commercial letters of credit. As described in section III.B.5 of this appendix A, purchases of subordinated securities or of servicing rights may give rise to a direct credit substitute. Direct credit substitutes also include the acquisition of risk participations in bankers acceptances and standby letters of credit, since both of these transactions, in effect, constitute a guarantee by the acquiring bank that the underlying account party (obligor) will repay its obligation to the originating, or issuing, institution.[41] (Standby letters of credit that are performance-related are discussed below and have a credit conversion factor of 50 percent.)

The full amount of a bank's exposure under a direct credit substitute is converted at 100 percent and the resulting credit equivalent amount is assigned to the risk category appropriate to the obligor or, if relevant, the guarantor or the nature of the collateral. In the case of a direct credit substitute in which a risk participation[42] has been conveyed, the full amount of the bank's exposure is still converted at 100 percent. However, the credit equivalent amount that has been conveyed is assigned to whichever risk category is lower: the risk category appropriate to the obligor, after giving effect to any relevant guarantees or collateral, or the risk category appropriate to the institution acquiring the participation. Any remainder is assigned to the risk category appropriate to the obligor, guarantor, or collateral. For example, the portion of a direct credit substitute conveyed as a risk participation to a U.S. domestic depository institution or foreign bank is assigned to the risk category appropriate to claims guaranteed by those institutions, that is, the 20 percent risk category.[43] This approach recognizes that such conveyances replace the originating bank's exposure to the obligor with an exposure to the institutions acquiring the risk participations.[44]

In the case of direct credit substitutes that take the form of a syndication as defined in the instructions to the commercial bank Call Report, that is, where each bank is obligated only for its *pro rata* share of the risk and there is no recourse to the originating bank, each bank will only include its *pro rata* share of its exposure under the direct credit substitute in its risk-based capital calculation.

Financial standby letters of credit are distinguished from loan commitments (discussed below) in that standbys are irrevocable obligations of the bank to pay a third-party beneficiary when a customer (account party) *fails to repay* an outstanding loan or debt instrument (direct credit substitute). Performance standby letters of credit (performance bonds) are irrevocable obligations of the bank to pay a third-party beneficiary when a customer (account party) *fails to perform* some other contractual non-financial obligation.

The distinguishing characteristics of a standby letter of credit for risk-based capital purposes is the combination of irrevocability with the fact that funding is triggered by some failure to repay or perform an obligation. Thus, any commitment (by whatever name) that involves an *irrevocable* obligation to make a payment to the customer or to a third-party in the event the customer *fails to repay* an outstanding debt obligation or *fails to perform* a contractual obligation is treated, for risk-based capital purposes, as respectively, a financial guarantee standby letter of credit or a performance standby.

A loan commitment, on the other hand, involves an obligation (with or without a material adverse change or similar clause) of the bank to fund its customer *in the normal course* of business should the customer seek to draw down the commitment.

Sale and repurchase agreements and asset sales with recourse (to the extent not included on the balance sheet) and forward agreements also are converted at 100 percent. Accordingly, the entire amount of any assets transferred with recourse that are not already included on the balance sheet, including pools of 1- to 4-family residential mortgages, is to be converted at 100 percent and assigned to the risk category appropriate to the obligor, or if relevant, the guarantor or the nature of the collateral. In certain recourse transactions (including those that are reported as a financing on a bank's balance sheet) the amount of the institution's contractual liability may be limited to an amount less than the effective risk-based capital requirement for the assets being transferred with recourse. In such cases, the amount of total capital that must be maintained against the transaction is equal to the maximum amount of possible loss under the recourse provision. So-called "loan strips" (that is, short-term advances sold under long-term commitments without direct recourse) are defined in the instructions to the commercial bank Call Report and for risk-based capital purposes as assets sold with recourse. The definition of the term "recourse" is set forth in section III.B.5 of this appendix A.

Forward agreements are legally binding contractual obligations to purchase assets with certain drawdown at a specified future date. Such obligations include forward purchases, forward forward deposits placed,[45] and partly-paid shares and securities; they do not include commitments to make residential mortgage loans or forward foreign exchange contracts.

Securities lent by a bank are treated in one of two ways, depending upon whether the lender is at risk of loss. If a bank, as agent for a customer, lends the customer's securities and does not indemnify the customer against loss, then the transaction is excluded from the risk-based capital calculation. If, alternatively, a bank lends its own securities, or acting as agent for a

[41] Credit-equivalent amounts of acquisitions of risk participations are assigned to the risk category appropriate to the account party obligor, or if relevant, the guarantor or the nature of the collateral.

[42] That is, a participation in which the originating banking organization remains liable to the beneficiary for the full amount of the direct credit substitute if the party that has acquired the participation fails to pay when the instrument is drawn.

[43] Risk participations with a remaining maturity of over one year that are conveyed to non-OECD banks are to be assigned to the 100 percent risk category, unless a lower risk category is appropriate to the obligor, guarantor, or collateral.

[44] A risk participation in bankers acceptances conveyed to other institutions is also assigned to the risk category appropriate to the institution acquiring the participation or, if relevant, the guarantor or nature of the collateral.

[45] Forward forward deposits accepted are treated as interest rate contracts.

customer, lends the customer's securities and indemnifies the customer against loss, the transaction is converted at 100 percent and assigned to the risk weight category appropriate to the obligor, to any collateral delivered to the lending bank, or, if applicable, to the independent custodian acting on the lender's behalf. Where a bank is acting as agent for a customer in a transaction involving the lending or sale of securities that is collateralized by cash delivered to the bank, the transaction is deemed to be collateralized by cash on deposit in the bank for purposes of determining the appropriate risk weight category, provided that any indemnification is limited to no more than the difference between the market value of the securities and the cash collateral received and any reinvestment risk associated with that cash collateral is borne by the customer.

* * * * *

PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL (REGULATION Y)

3. The authority citation for part 225 is revised to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1831i, 1831p-1, 1843(c)(8), 1844(b), 1972(l), 3106, 3108, 3310, 3331–3351, 3907, and 3909.

4. Section III of appendix A to part 225 is amended by adding a new paragraph B.5 and by revising the introductory text of paragraph D and paragraph D.1 to read as follows:

Appendix A to Part 225—Capital Adequacy Guidelines for Bank Holding Companies: Risked-Based Measure

* * * * *

III. Procedures for Computing Weighted Risk Assets and Off-Balance Sheet Items

* * * * *

B. * * *

5. *Recourse Arrangements and Direct Credit Substitutes.* Banking organizations may engage in activities—such as securitizing pools of assets, selling single assets, and entering into certain off-balance sheet transactions—that result in the provision of a credit enhancement in the form of a recourse arrangement or a direct credit substitute. The risk-based capital treatment of recourse arrangements and direct credit substitutes is discussed in section III.D of this appendix A. The following definitions of the terms "recourse" and "direct credit substitute" apply for risk-based capital purposes.

Recourse is the retention, in form or in substance, of any risk of loss directly or indirectly associated with an asset a banking organization has transferred that is in excess of the banking organization's *pro rata* share of the asset. A recourse arrangement typically arises when an institution transfers an asset and retains an obligation to repurchase the asset or to absorb losses on the asset arising from (a) a default of principal or interest or (b) any other deficiencies in the performance of the underlying obligor or some other party.

A direct credit substitute is the assumption, in form or substance through a nonrecourse arrangement, of any risk of loss directly or indirectly associated with an asset or other claim in excess of the banking organization's *pro rata* share of the asset or other claim. A direct credit substitute arrangement typically arises when an institution issues a standby letter of credit, purchases a subordinated security that provides loss protection to more senior securities, or purchases servicing rights, such as mortgage servicing rights, that obligate the servicer to provide credit protection to the third-party owners of the assets being serviced.

For most direct credit substitutes, the amount of the banking organization's exposure to be converted to an on-balance sheet credit equivalent typically is the full face value of the item. However, for direct credit substitutes, such as purchased subordinated securities that are carried on the balance sheet that directly or indirectly absorb the first losses from a third-party asset, pool of assets, or other claim, the full amount of the banking organization's off-balance sheet exposure that is to be converted is the entire outstanding principal amount of the asset, pool of assets, or other claim, less the amount of the on-balance sheet direct credit substitute against which capital is already held. This treatment applies regardless of whether the direct credit substitute fully or partially supports the asset, pool of assets, or other claim. The full amount of the banking organization's off-balance sheet exposure may be the same or greater than the face amount of the direct credit substitute. For instance, in the case of purchased subordinated securities that absorb first losses, the entire outstanding principal amount of all more senior securities that are supported by that subordinated interest (to the extent they are not already reported on the banking organization's balance sheet) are converted to an on-balance sheet credit equivalent amount.

For risk-based capital purposes, non-standard representations or warranties a banking organization may extend in transferring assets (including the transfer of servicing rights), or may assume in other transactions, including the acquisition of loan servicing rights, are treated as recourse or direct credit substitutes.[27a] Standard representations and warranties, which normally do not constitute recourse or direct credit substitutes for risk-based capital purposes, are contractual provisions referring to an existing set of facts that has been verified with reasonable due diligence by the seller or servicer at the time the assets are transferred or loan servicing rights are acquired. Standard representations and warranties also include contractual provisions that provide for the return of the assets to the seller in instances of fraud or upon determination by the purchaser that the assets transferred are not fully and properly documented or otherwise as represented by the seller.

A cash advance by a loan servicer does not constitute recourse or a direct credit substitute if the servicer is entitled to full reimbursement, or for any one loan, nonreimbursable amounts are contractually limited to an insignificant amount of the outstanding principal on that loan. A servicer cash advance is an arrangement under which the servicer advances funds to ensure an uninterrupted flow of payments to investors or the timely collection of loans. Funds advanced to ensure the timely collection of loans include disbursements made to cover foreclosure costs or other expenses incurred to facilitate the timely collection of a loan.

* * * * *

D. * * *

Before an off-balance sheet item can be incorporated into the risk-based capital ratio, the on-balance sheet credit-equivalent amount of the item must be determined. Once the credit-equivalent is determined, the amount is then assigned to the appropriate risk category according to the obligor, or, if relevant, the guarantor or the nature of the collateral.[43] The method for determining the credit-equivalent amount of an interest-rate or exchange-rate contract is set forth in section III.E.2 of this appendix A. For most other types of off-balance sheet items, the on-balance sheet credit-equivalent amount is determined by multiplying the full amount of the banking organization's exposure under the item by the applicable credit conversion factor as set forth below and in Attachment IV to this appendix A.

However, in the case of direct credit substitutes—which are described in detail in sections III.B.5 and III.D.1 of this appendix A—that directly or indirectly absorb the first losses from an asset, pool of assets, or other claim, the full amount of a banking organization's exposure that is to be converted is the entire outstanding principal amount of the asset, pool of assets, or other claim, less the amount of any on-balance sheet exposure associated with the item against which capital is already held. This treatment applies regardless of whether the direct credit substitute fully or partially supports the asset, pool of assets, or other claim. The full amount of banking organization's exposure may be the same or greater than the face amount of the direct credit substitute. For instance, in the case of standby letters of credit that absorb first losses, the entire outstanding principal amount of a customer's loan or debt instrument that is supported by the letter of credit is converted to an on-balance sheet credit equivalent amount.

Generally, the full face value of an off-balance sheet item is converted to an on-balance sheet credit equivalent amount and

[27a] *Representations* are statements, express or implied, regarding a past or existing fact, circumstance, or state of facts pertinent to a contract, which is influential in bringing about the agreement. *Warranties* are promises that certain facts are truly as they are represented to be and that they will remain so, subject to specified limitations.

[43] The sufficiency of collateral and guarantees for off-balance sheet items is determined by the market value of the collateral or the amount of the guarantee in relation to the face amount of the item, except for interest- and exchange-rate contracts, for which this determination is made in relation to the credit-equivalent amount. Collateral and guarantees are subject to the same provisions noted under section III.B of this Appendix A.

incorporated in weighted risk assets and, thus, is subject to a full effective risk-based capital requirement. However, the aggregate capital requirement on a first loss direct credit substitute or a recourse transaction is limited to the maximum contractual amount of loss to which the direct credit substitute or recourse arrangement exposes the institution if this amount is less than the effective risk-based capital charge for the asset, pool of assets, or other claim supported by the direct credit substitute or recourse arrangement.

1. *Items with a 100 percent conversion factor.* A 100 percent conversion factor applies to direct credit substitutes, which include guarantees, or equivalent instruments, backing financial claims such as outstanding securities, loans, and other financial liabilities, or that back off-balance sheet items that require capital under the risk-based capital framework. Direct credit substitutes include, for example, financial standby letters of credit, or other equivalent irrevocable undertakings or surety arrangements, that guarantee repayment of financial obligations such as: commercial paper, tax-exempt securities, commercial or individual loans or debt obligations, or standby or commercial letters of credit. As described in section III.B.5 of this appendix A, purchases of subordinated securities or of servicing rights may give rise to a direct credit substitute. Direct credit substitutes also include the acquisition of risk participations in bankers acceptances and standby letters of credit, since both of these transactions, in effect, constitute a guarantee by the acquiring banking organization that the underlying account party (obligor) will repay its obligation to the originating, or issuing, institution.[44] (Standby letters of credit that are performance-related are discussed below and have a credit conversion factor of 50 percent.)

The full amount of a banking organization's exposure under a direct credit substitute is converted at 100 percent and the resulting credit-equivalent amount is assigned to the risk category appropriate to the obligor or, if relevant, the guarantor or the nature of the collateral. In the case of a direct credit substitute in which a risk participation[45] has been conveyed, the full amount of the banking organization's exposure is still converted at 100 percent. However, the credit-equivalent amount that has been conveyed is assigned to whichever risk category is lower: the risk category appropriate to the obligor, after giving effect to any relevant guarantees or collateral, or the risk category appropriate to the institution acquiring the participation. Any remainder is assigned to the risk category appropriate to the obligor, guarantor, or collateral. For example, the portion of a direct credit substitute conveyed as a risk participation to a U.S. domestic depository institution or foreign bank is assigned to the risk category appropriate to claims guaranteed by those institutions, that is, the 20 percent risk category.[46] This approach recognizes that such conveyances replace the originating banking organization's exposure to the obligor with an exposure to the institutions acquiring the risk participations.[47]

In the case of direct credit substitutes that take the form of a syndication, that is, where each banking organization is obligated only for its *pro rata* share of the risk and there is no recourse to the originating banking organization, each banking organization will only include its *pro rata* share of its exposure under the direct credit substitute in its risk-based capital calculation.

Financial standby letters of credit are distinguished from loan commitments (discussed below) in that standbys are irrevocable obligations of the banking organization to pay a third-party beneficiary when a customer (account party) *fails to repay* an outstanding loan or debt instrument (direct credit substitute). Performance standby letters of credit (performance bonds) are irrevocable obligations of the banking organization to pay a third-party beneficiary when a customer (account party) *fails to perform* some other contractual non-financial obligation.

The distinguishing characteristics of a standby letter of credit for risk-based capital purposes is the combination of irrevocability with the fact that funding is triggered by some failure to repay or perform an obligation. Thus, any commitment (by whatever name) that involves an *irrevocable* obligation to make a payment to the customer or to a third-party in the event the customer *fails to repay* an outstanding debt obligation or *fails to perform* a contractual obligation is treated, for risk-based capital purposes, as respectively, a financial guarantee standby letter of credit or a performance standby.

A loan commitment, on the other hand, involves an obligation (with or without a material adverse change or similar clause) of the banking organization to fund its customer *in the normal course* of business should the customer seek to draw down the commitment.

Sale and repurchase agreements and asset sales with recourse (to the extent not included on the balance sheet) and forward agreements also are converted at 100 percent.[48] So-called "loan strips" (that is, short-term advances sold under long-term commitments without direct recourse) are treated for risk-based capital purposes as assets sold with recourse and, accordingly, are also converted at 100 percent. The definition of the term "recourse" is set forth in section III.B.5 of this appendix A.

Forward agreements are legally binding contractual obligations to purchase assets with certain drawdown at a specified future date. Such obligations include forward purchases, forward deposits placed,[49] and partly-paid shares and securities; they do not include commitments to make residential mortgage loans or forward foreign exchange contracts.

Securities lent by a banking organization are treated in one of two ways, depending upon whether the lender is at risk of loss. If a banking organization, as agent for a customer, lends the customer's securities and does not indemnify the customer against loss, then the transaction is excluded from the risk-based capital calculation. If, alternatively, a banking organization lends its own securities, or acting as agent for a customer, lends the customer's securities and indemnifies the customer against loss, the transaction is converted at 100 percent and assigned to the risk weight category appropriate to the obligor, to any collateral delivered to the lending banking organization, or, if applicable, to the independent custodian acting on the lender's behalf. Where a banking organization is acting as agent for a customer in a transaction involving the lending or sale of securities that is collateralized by cash delivered to the banking organization, the transaction is deemed to be collateralized by cash on deposit in the banking organization for purposes of determining the appropriate risk weight category, provided that any indemnification is limited to no more than the difference between the market value of the securities and the cash collateral received and any reinvestment risk associated with that cash collateral is borne by the customer.

* * * * *

[44] Credit-equivalent amounts of acquisitions of risk participations are assigned to the risk category appropriate to the account party obligor, or if relevant, the guarantor or nature of the collateral.

[45] That is, a participation in which the originating banking organization remains liable to the beneficiary for the full amount of the direct credit substitute if the party that has acquired the participation fails to pay when the instrument is drawn.

[46] Risk participations with a remaining maturity of over one year that are conveyed to non-OECD banks are to be assigned to the 100 percent risk category, unless a lower risk category is appropriate to the obligor, guarantor, or collateral.

[47] A risk participation in bankers acceptances conveyed to other institutions is also assigned to the risk category appropriate to the institution acquiring the participation or, if relevant, the guarantor or nature of the collateral.

[48] In the regulatory reports and under GAAP, bank holding companies are permitted to treat some asset sales with recourse as "true" sales. For risk-based capital purposes, however, such assets sold with recourse and reported as "true" sales by bank holding companies are converted at 100 percent and assigned to the risk category appropriate to the underlying obligor or, if relevant the guarantor or nature of the collateral, provided that the transactions meet the definition of assets sold with recourse, including the sale of 1- to 4-family residential mortgages, that is contained in the instructions to the commercial bank Consolidated Reports of Condition and Income (Call Report). Accordingly, the entire amount of any assets transferred with recourse that are not already included on the balance sheet, including pools of 1- to 4-family residential mortgages, is to be converted at 100 percent and assigned to the risk category appropriate to the obligor, or if relevant, the guarantor or the nature of the collateral. In certain recourse transactions the amount of the institution's contractual liability may be limited to an amount less than the effective risk-based capital requirement for the assets being transferred with recourse. In such cases, the amount of total capital that must be maintained against the transaction is equal to the maximum amount of possible loss under the recourse provision.

[49] Forward forward deposits accepted are treated as interest rate contracts.

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Chapter III

Authority and Issuance

For the reasons set forth in the preamble, the Board of Directors of the Federal Deposit Insurance Corporation proposes to amend part 325 of title 12 of the Code of Federal Regulations as follows:

PART 325—CAPITAL MAINTENANCE

1. The authority citation for part 325 continues to read as follows:

Authority: 12 U.S.C. 1815(a), 1815(b), 1816, 1818(a), 1818(b), 1818(c), 1818(t), 1819(Tenth), 1828(c), 1828(d), 1828(i), 1828(n), 1828(o), 1831o, 3907, 3909; Pub. L. 102–233, 105 Stat. 1761, 1789, 1790 (12 U.S.C. 1831n note); Pub. L. 102–242, 105 Stat. 2236, 2355, 2386 (12 U.S.C. 1828 note).

2. Section II of appendix A to part 325 is amended by:

a. Adding paragraph 6 to section II.B;

b. Removing the undesignated introductory paragraph in section II.D and adding in its place three new paragraphs; and

c. Revising the first and the second through fifth paragraphs under paragraph 1 in section II.D, to read as follows:

Appendix A to Part 325—Statement of Policy on Risk-Based Capital

* * * * *

II. Procedures For Computing Risk-Weighted Assets

* * * * *

B. * * *

6. *Recourse Arrangements and Direct Credit Substitutes.* For purposes of determining the risk-based capital treatment of securitized pools of assets, sales of single assets, and certain off-balance sheet transactions in which a bank provides credit enhancement, the following definitions of the terms "recourse" and "direct credit substitute" apply. The risk-based capital treatment of recourse arrangements and direct credit substitutes is discussed in section II.D of this appendix A.

Recourse is the retention, in form or in substance, of any risk of loss directly or indirectly associated with an asset a bank has transferred that is in excess of the bank's pro rata share of the asset. A recourse arrangement typically arises when an institution transfers an asset and retains an obligation to repurchase the asset or to absorb losses on the asset arising from: (a) a default of principal or interest or (b) any other deficiencies in the performance of the underlying obligor or some other party.

A *direct credit substitute* is the assumption, in form or in substance through a nonrecourse arrangement, of any risk of loss directly or indirectly associated with an asset or other claim in excess of the bank's pro rata share of the asset or other claim. A direct credit substitute arrangement typically arises when an institution issues a financial standby letter of credit, purchases a subordinated security that provides loss protection to more senior securities, or purchases servicing rights, such as mortgage servicing rights, that obligate the servicer to provide credit protection to the third party owners of the assets being serviced.

For most direct credit substitutes, the amount of the bank's exposure to be converted into an on-balance sheet credit equivalent amount typically is the full face value of the direct credit substitute. However, for direct credit substitutes carried on the balance sheet that directly or indirectly absorb the first losses from an asset, pool of assets, or other claim, the full amount of the bank's off-balance sheet exposure that is to be converted is the entire outstanding principal amount of the asset, pool of assets, or other claim, less the amount of the on-balance sheet direct credit substitute which is itself being assigned to one of the four broad risk weight categories. This treatment applies regardless of whether the direct credit substitute fully or partially supports the asset, pool of assets, or other claim. The full amount of the bank's exposure to be converted may be the same or greater than the face value of the direct credit substitute. For instance, in the case of purchased subordinated securities that absorb first losses, the entire outstanding principal amount of all more senior securities that are supported by that subordinated interest (to the extent they are not already reported on the bank's balance sheet) are converted to an on-balance sheet credit equivalent amount.

For risk-based capital purposes, nonstandard representations or warranties that a bank may extend in transferring assets (including the transfer of servicing rights) or assume in other transactions (including the acquisition of loan servicing rights) are treated as recourse or direct credit substitutes. *Standard representations and warranties,* which normally do not constitute recourse or direct credit substitutes for risk-based capital purposes, are contractual provisions referring to an existing set of facts that has been verified with reasonable due diligence by the seller or servicer at the time the assets are transferred or loan servicing rights are acquired. Standard representations and warranties are also generally accompanied by contractual provisions that provide for the return of the assets to the seller in instances of fraud or upon determination by the purchaser that the assets transferred are not fully and properly documented or otherwise as represented by the seller.

A *servicer cash advance* is an arrangement under which the servicer of a loan advances funds to ensure an uninterrupted flow of payments to investors or the timely collection of loans. Funds advanced to ensure the timely collection of loans include disbursements made to cover foreclosure costs or other expenses incurred to facilitate the timely collection of a loan. A servicer cash advance does not constitute recourse or a direct credit substitute if: (a) the servicer is entitled to full reimbursement for the amount of the advance or (b) for any one loan, nonreimbursable amounts are contractually limited to an insignificant amount of the outstanding principal on that loan.

* * * * *

D. * * *

In order for an off-balance sheet item to be incorporated into a bank's risk-weighted assets, the on-balance sheet *credit equivalent amount* of the item must first be determined. Once the credit equivalent amount is determined, this amount is assigned to the appropriate risk category according to the obligor or, if relevant, the guarantor or the nature of the collateral. The method for determining the credit equivalent amount of an interest rate or foreign exchange rate contract is set forth in section II.E.1 of this appendix A. For most other types of off-balance sheet items, the on-balance sheet credit equivalent amount is determined by multiplying the *full amount of the bank's exposure* under the item by the applicable *credit conversion factor* as set forth below.

However, in the case of direct credit substitutes—which are described in detail in sections II.B.6 and II.D.1 of this appendix A—that directly or indirectly absorb the first losses from an asset, pool of assets, or other claim, the full amount of the bank's exposure that must be converted to a credit equivalent amount is the entire outstanding principal amount of the asset, pool of assets, or other claim, less the amount of any on-balance sheet exposure associated with the item which is itself being assigned to one of the four risk weight categories. This treatment applies regardless of whether the direct credit substitute fully or partially supports the asset, pool of assets, or other claim. The full amount of the bank's exposure that must be converted to a credit equivalent amount may be the same as or greater than the face value of the direct credit substitute. For instance, in the case of financial standby letters of credit that absorb first losses, the entire outstanding principal amount of the customer's loan or debt instrument that is supported by the letter of credit is converted to an on-balance sheet credit equivalent amount.

Generally, the full amount of the bank's exposure under an off-balance sheet item is converted to an on-balance sheet credit equivalent amount and then incorporated in risk-weighted assets and, thus, is subject to a full effective risk-based capital charge. However, the aggregate capital requirement on a first loss direct credit substitute or a recourse transaction (including a transaction reported as a financing on a bank's balance sheet) is limited to the maximum contractual amount of loss to which the direct credit substitute or recourse arrangement exposes the bank if this amount is less than the full effective risk-based capital charge for the asset, pool of assets, or other claim that is supported by the bank.

1. *Items With a 100 Percent Conversion Factor.* A 100 percent conversion factor applies to *direct credit substitutes,* which include *guarantees,* or equivalent instruments, backing *financial* claims, such as outstanding securities, loans, and other financial obligations, or backing off-balance sheet items that require capital under the

risk-based capital framework. These direct credit substitutes include, for example, *financial standby letters of credit*, or other equivalent irrevocable undertakings or surety arrangements, that effectively guarantee repayment of financial obligations such as: commercial paper, tax-exempt securities, commercial or individual loans or other debt obligations, or standby or commercial letters of credit. As described in section II.B.6 of this appendix A, purchases of *subordinated securities* or of *servicing rights* may give rise to a direct credit substitute. The full amount of a bank's exposure under a direct credit substitute is converted at 100 percent and the resulting credit equivalent amount is assigned to the risk category appropriate to the obligor or, if relevant, the guarantor or the nature of the collateral.

* * * * *

Therefore, the distinguishing characteristics of a financial standby letter of credit for risk-based capital purposes is the combination of irrevocability with the notion that funding is triggered by some failure to repay or perform on a financial obligation. Thus, any commitment (by whatever name) that involves an *irrevocable* obligation to make a payment to the customer or to a third party in the event the customer *fails to repay* an outstanding debt obligation will be treated, for risk-based capital purposes, as a financial standby letter of credit and the full amount of the bank's exposure under the letter of credit will be assigned a 100 percent conversion factor. (Performance-related standby letters of credit are assigned a conversion factor of 50 percent.)

A bank that has conveyed a *risk participation*[35] in a direct credit substitute to a third party should convert the full amount of its exposure under the direct credit substitute at a 100 percent conversion factor without deducting the risk participations conveyed. However, portions of direct credit substitutes that have been conveyed as risk participations to U.S. depository institutions and OECD banks may then be assigned to the 20 percent risk category that is appropriate for claims guaranteed by U.S. depository institutions and OECD banks, rather than to the risk category appropriate to the account party obligor.[36] A bank acquiring a risk participation in a direct credit substitute or bankers acceptance should convert the full amount of its exposure under the participation at 100 percent and then assign the credit equivalent amount to the risk category that is appropriate to the account party obligor or, if relevant, the guarantor or the nature of the collateral.

In the case of direct credit substitutes that are structured in the form of a *syndication* as defined in the instructions for the preparation of the Consolidated Reports of Condition and Income (that is, where each bank is obligated only for its *pro rata* share of the risk and there is no recourse to the originating bank), each bank will only include its *pro rata* share of its exposure under the direct credit substitute in its risk-based capital calculation.

Sale and repurchase agreements and *asset sales with recourse*, if not already included on the balance sheet, and *forward agreements* are also converted at 100 percent. Accordingly, the entire amount of any assets transferred with recourse that are not already included on the balance sheet, including pools of one-to-four family residential mortgages, is to be converted at 100 percent and assigned to the risk category appropriate to the obligor or, if relevant, the guarantor or the nature of the collateral. In certain recourse transactions (including those that are reported as financings on a bank's balance sheet) the amount of the bank's contractual liability may be limited to an amount less than the full effective risk-based capital requirement for the assets being transferred with recourse. In such cases, the amount of capital that must be maintained against the transaction is limited to the maximum amount of possible loss under the recourse provision. So-called "loan strips" and similar arrangements involving short-term loans sold by a bank without direct recourse but subject to long-term loan commitments by the bank are accorded the same treatment for risk-based capital purposes as assets sold with recourse. The definition of the term "recourse" is set forth in section II.B.6 of this appendix A. Forward agreements are legally binding contractual obligations to purchase assets with drawdown which is *certain* at a specified future date. These obligations include forward purchases, forward deposits placed, and partly paid shares and securities but do not include forward foreign exchange rate contracts or commitments to make residential mortgage loans.

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DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

12 CFR Chapter V

Authority and Issuance

For the reasons set out in the preamble, part 567 of chapter V of title 12 of the Code of Federal Regulations is proposed to be amended as follows:

SUBCHAPTER D—REGULATIONS APPLICABLE TO ALL SAVINGS ASSOCIATIONS

PART 567—CAPITAL

1. The authority citation for part 567 continues to read as follows:

Authority: 12 U.S.C. 1462, 1462a, 1463, 1464, 1476a, 1828(note).

2. Section 567.1 is amended by revising paragraphs (f) and (kk) and by adding new paragraphs (mm), (nn), (oo) and (pp) to read as follows:

§ 567.1 Definitions.

* * * * *

(f) *Direct credit substitute.* The term *direct credit substitute* means the assumption, in form or substance (other than recourse obligations as defined in § 567.1(kk)), of any risk of loss directly or indirectly associated with an asset or other claim, that exceeds the savings association's pro rata share of the asset or claim. If a savings association has no claim on an asset, the assumption of any risk of loss is a direct credit substitute. Direct credit substitutes include, but are not limited to:

(1) Financial guarantee-type standby letters of credit that support financial claims on the account party;

(2) Guarantees and guarantee-type instruments backing financial claims;

(3) Purchased subordinated interests or securities that absorb more than their pro rata share of losses from the underlying assets; and

(4) Purchased loan servicing rights if the servicer is responsible for losses associated with the loans being serviced (other than servicer cash advances as defined in § 567.1(nn)), or if the servicer makes or assumes representations or warranties about the loans (other than standard representations and warranties as defined in § 567.1(oo)).

* * * * *

(kk) *Recourse.* The term *recourse* means the retention, in form or substance, of any risk of loss directly or indirectly associated with a transferred asset, that exceeds a pro rata share of the savings association's claim on the asset. If the savings association has no claim on a transferred asset, the retention of any risk of loss is recourse. A recourse obligation typically arises when an institution transfers assets and retains an obligation to repurchase the assets, or to absorb losses due to: a default of principal or interest; or any other deficiency in the performance of the underlying obligor or some other party. Recourse arrangements include, but are not limited to:

(1) Representations or warranties about the transferred assets other than standard representations and warranties as defined in § 567.1(oo);

(2) Retained loan servicing rights if the servicer is responsible for losses associated with the loans serviced (other than servicer cash advances as defined in § 567.1(nn));

(3) Retained subordinated interests or securities that absorb more than a pro rata share of losses from the underlying assets;

(4) Assets sold under an agreement to repurchase; and

(5) Loan strips sold without direct recourse where the maturity of the

[35] That is, participations in which the originating bank remains liable to the beneficiary for the full amount of the direct credit substitute if the party that has acquired the participation fails to pay when the instrument is drawn upon.

[36] Risk participations with a remaining maturity of one year or less that are conveyed to non-OECD banks are also assigned to the 20 percent risk weight category.

participation is shorter than the maturity of the underlying loan.

* * * * *

(mm) *Public-sector entities.* The term *public-sector entities* includes states, local authorities and governmental subdivisions below the central government level in an OECD-based country. In the United States, this definition encompasses a state, county, city, town or other municipal corporation, a public authority, and generally any publicly-owned entity that is an instrumentality of a state or municipal corporation. This definition does not include commercial companies owned by the public sector.

(nn) *Servicer cash advances.* The term *servicer cash advances* means funds that a loan servicer advances to ensure an uninterrupted flow of payments or the timely collection of loans, including disbursements made to cover foreclosure costs or other expenses arising from a loan to facilitate its timely collection. A servicer cash advance is not a recourse arrangement (as defined in § 567.1(kk)) or a direct credit substitute (as defined in § 567.1(ff)), if:

(1) The servicer is entitled to full reimbursement; or

(2) For any one loan, nonreimbursed advances are contractually limited to an insignificant amount of the outstanding principal on that loan.

(oo) *Standard representations and warranties.* The term *standard representations and warranties* means contractual provisions that a savings association extends when it transfers assets (including loan servicing rights) or assumes when it purchases loan servicing rights, that refer to existing facts at the time the assets are transferred or the servicing rights are acquired, and that have been verified with reasonable due diligence by the transferor or servicer. Standard representations and warranties also include contractual provisions for the return of assets in the event of fraud or documentation deficiencies. Standard representations and warranties are not recourse obligations as defined in § 567.1(kk) or direct credit substitutes as defined in § 567.1(ff).

(pp) *Standby letters of credit.* (1) A financial guarantee-type standby letter of credit is any letter of credit, or similar arrangement, however named or described, which represents an irrevocable obligation to the beneficiary on the part of the issuer:

(i) To repay money borrowed by or advanced to or for the account of the account party; or

(ii) To make payment on account of any indebtedness undertaken by the account party, in the event that the account party fails to fulfill its obligation to the beneficiary.

(2) A performance-based standby letter of credit is any letter of credit, or similar arrangement, however named or described, which represents an irrevocable obligation to the beneficiary on the part of the issuer to make payment on account of any default by the account party in the performance of a nonfinancial or commercial obligation.

3. In § 567.6, the first sentence of paragraph (a)(2) introductory text is revised, the fifth sentence of paragraph (a)(2) introductory text is removed, paragraph (a)(2)(i)(A) and (C) are removed and reserved, paragraph (a)(2)(i)(B) is revised, and a new paragraph (a)(3) is added to read as follows:

§ 567.6 Risk-based capital credit risk weight categories.

(a) * * *

(2) *Off-balance sheet activities.* Except for recourse obligations and direct credit substitutes which are specifically discussed in paragraph (a)(3) of this section, risk weights for off-balance sheet items are determined by the following two-step process. * * *

(i) * * *

(A) [Reserved]

(B) Risk participations purchased in bankers acceptances;

(C) [Reserved]

* * * * *

(3) *Recourse arrangements and direct credit substitutes*—(i) *Risk-weighted asset amounts.* To calculate the risk-weighted asset amount for a recourse arrangement or for a direct credit substitute, multiply the on-balance sheet credit equivalent amount by the appropriate risk weight using the criteria regarding obligors, guarantors, and collateral listed in paragraph (a)(1) of this section.

(ii) *On-balance sheet credit equivalent amount.* Except as otherwise provided by this paragraph (a)(3), the on-balance sheet credit equivalent amount for a recourse arrangement or direct credit substitute is the amount of assets from which risk of loss is directly or indirectly retained or assumed. For the purposes of this paragraph (a)(3), the amount of assets from which risk of loss is directly or indirectly assumed or retained means:

(A) For a financial guarantee-type standby letter of credit, guarantee, or other guarantee-type arrangement, the assets that the direct credit substitute fully or partially supports;

(B) For a subordinated interest or security, the amount of the subordinated interest or security plus all more senior interests or securities;

(C) For mortgage servicing rights that are recourse arrangements or direct credit substitutes, the outstanding amount of the loans serviced;

(D) For representations and warranties (other than standard representations and warranties), the amount of the loans subject to the representations or warranties;

(E) For assets sold with recourse, the amount of assets from which risk of loss is directly or indirectly retained excluding the amount of the recourse liability account established in accordance with GAAP standards; and

(F) For loans strips that are recourse arrangements or direct credit substitutes, the amount of the loans.

(iii) *Second-loss position direct credit substitutes.* The on-balance sheet credit equivalent amount for certain direct credit substitutes is the face amount of the direct credit substitute if:

(A) There is a prior credit enhancement that absorbs the first dollars of loss from the underlying assets that the direct credit substitute fully or partially supports; and

(B) The direct credit substitute is a financial guarantee-type standby letter of credit, a guarantee or other guarantee-type arrangement that absorbs the second dollars of loss from the underlying assets.

(iv) *Participations.* The on-balance sheet credit equivalent amount for a participation interest in a financial guarantee-type standby letter of credit, a guarantee or other guarantee-type is calculated as follows:

(A) Determine the on-balance credit sheet equivalent amount as if the savings association held all of interests in the participation. See paragraph (a)(3)(ii) of this section (direct credit substitute in the first loss position) and paragraph (a)(3)(iii) of this section (direct credit substitute in the second loss position).

(B) Multiply the on-balance sheet credit equivalent amount determined under paragraph (a)(3)(iv)(A) of this section by the percentage of the savings association's participation interest.

(C) If the savings association is exposed to more than its pro rata share of the risk of loss on the direct credit substitute (*e.g.*, the savings association remains secondarily liable on participations held by others), add to the amount computed under paragraph (a)(3)(iv)(B) of this section, an amount computed as follows: multiply the amount computed under paragraph (a)(3)(iv)(A) of this section, by the percent of the direct credit substitute held by others and the multiply the

result by the risk-weight appropriate for other holders of those interest. (Note: This risk-weighting is in addition to the risk-weighting done to convert the on-balance sheet credit equivalent amount to the risk-weighted asset amount under paragraph (a)(3)(i) of this section.)

(v) *Related on-balance sheet assets.* To the extent that an asset is included in the calculation of the capital requirement for a recourse arrangement or direct credit substitute under this paragraph (a)(3), and may also be included as an on-balance sheet asset under paragraph (a)(1) of this section, the asset shall be risk-weighted only under this paragraph (a)(3) except:

(A) Excess mortgage servicing rights that are recourse arrangements, and purchased mortgage servicing rights and purchased credit card relationships that are direct credit substitutes are risk weighted as on-balance sheet assets under paragraph (a)(1) of this section, and the related recourse arrangements and direct credit substitutes are risk weighted under this paragraph (a)(3).

(B) Purchased subordinated interests that are high quality mortgage-related securities are not subject to risk-weighting under this paragraph (a)(3). Rather, these assets are risk weighted as on-balance sheet assets under paragraph (a)(1)(ii)(H) of this section.

(vi) *Limitations on risk-based capital requirement*—(A) *Low-level exposure.* If the maximum contractual liability or exposure to loss retained or assumed by a savings association in connection with a recourse arrangement or direct credit substitute is less than the capital required to support the recourse obligation or direct credit substitute, the capital requirement is limited to the maximum contractual liability or exposure to loss. For assets sold with recourse, the amount of capital required to support the recourse obligation is limited to the maximum contractual liability or exposure to loss less the amount of the recourse liability account established in accordance with GAAP standards.

(B) *Mortgage-related securities or participation certificates retained in a mortgage loan swap.* If a savings association holds a mortgage related security or a participation certificate as a result of a mortgage loan swap with recourse, capital is required to support that percentage of the mortgage related security or participation certificate that is not covered by the recourse obligation, and the recourse obligation. The total amount of capital required for the on-balance sheet asset and the recourse obligation, however, is limited to the capital requirement for the underlying loans, calculated as if the savings association continued to hold these loans as an on-balance sheet asset.

(vii) *Obligations of subsidiaries.* If a savings association retains a recourse arrangement or assumes a direct credit substitute on the obligation of a subsidiary that is not an includable subsidiary and the recourse obligation or direct credit substitute is an equity investment in the subsidiary under GAAP standards, the face amount of the recourse obligation or direct credit substitute is deducted from capital under §§ 567.5(a)(2) and 567.9(c). All other recourse obligations and direct credit substitutes retained or assumed by a savings association on the obligations of a subsidiary are risk-weighted in accordance with paragraphs (a)(3) (i) through (vi) of this section.

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Dated: December 8, 1993.

Eugene A. Ludwig,

Comptroller of the Currency.

By order of the Board of Directors.

Dated at Washington, DC, this 12th day of April, 1994.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Acting Executive Secretary.

Dated: May 4, 1994.

Board of Governors of the Federal Reserve System.

William W. Wiles,

Secretary of the Board.

Dated: December 15, 1993.

By the Office of Thrift Supervision.

Jonathan L. Fiechter,

Acting Director.

[FR Doc. 94–11513 Filed 5–24–94; 8:45 am]

BILLING CODE 4810–33–P, 6210–01–P, 6714–01–P, 6720–01–P