FEDERAL RESERVE BANK
OF DALLAS

DALLAS, TEXAS
75265-5906

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Notice 02-26

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

SUBJECT

Regulatory Capital Treatment of Accrued Interest Receivables Related to Credit Card Securitizations

DETAILS

The federal banking agencies have identified inconsistencies across financial institutions in the regulatory capital treatment of accrued interest receivables (AIRs) related to credit card securitizations. The agencies have worked together and developed guidance that clarifies the appropriate risk-based capital treatment for banking organizations that securitize credit card receivables and record on-balance sheet assets commonly referred to as AIRs.

As further detailed in the guidance, when a banking organization transfers a pool of credit card receivables to a trust, it typically also transfers to the trust the right to receive interest and fee income from those receivables. Some institutions continue to accrue interest and fee income on the investors' portion of the transferred credit card receivables on their balance sheets, reporting the right to these future cash flows as an AIR asset. Any accrued amounts the banking organization collects, however, generally must be transferred to the trust upon collection. Because the banking organization passes all cash flows related to the AIR to the trust, where they are available to satisfy more senior obligations before excess amounts are returned to the seller, the AIR constitutes a residual interest in the securitized assets. The AIR serves as a credit enhancement to protect third party investors in the securitization from credit losses and meets the definition of a "residual interest" under the banking agencies' rules on the capital treatment of recourse arrangements issued in November 2001, which are specifically referenced in footnote 3 of the attachment. Under those rules, an institution must hold "dollar-for-dollar" capital against residual interests even if that amount exceeds the full equivalent risk-based capital charge on the transferred assets.

The banking agencies expect banking organizations to reflect the aforementioned treatment in their regulatory reports by no later than December 31, 2002. Institutions that have been properly reflecting the AIR asset as a credit enhancement for risk-based capital purposes are expected to continue to do so. Notwithstanding these expectations, the banking agencies highlight in their guidance that there may be circumstances where a banking organization may have to treat the AIR asset in the way described by the guidance at an earlier date due to supervisory concerns or other factors.

ATTACHMENT

A copy of the interagency guidance is attached.

MORE INFORMATION

For more information, please contact Dorsey Davis, Banking Supervision Department, at (214) 922-6051. Paper copies of this notice or previous Federal Reserve Bank notices can be printed from our web site at **http://www.dallasfed.org/banking/notices/index.html**.

Interagency Advisory on the Regulatory Capital Treatment of Accrued Interest Receivable Related to Credit Card Securitizations

Purpose

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the agencies) are issuing this advisory to clarify the appropriate risk-based capital treatment for banking organizations (institutions) that securitize credit card receivables and record an on-balance sheet asset commonly referred to as an Accrued Interest Receivable (AIR).[1]

In general, the AIR asset represents a subordinated retained interest in cash flows that are initially allocated to the investors' portion of a credit card securitization. The AIR is subject to higher capital requirements under the agencies' capital standards than many institutions are currently applying to this asset. The agencies expect institutions to hold capital for AIR assets consistent with the agencies' positions articulated in this advisory by no later than December 31, 2002, unless supervisory concerns warrant an institution's earlier application of this advisory. Institutions that have been properly reflecting the AIR as a credit enhancement for risk-based capital purposes are expected to continue to do so.

Creation of Accrued Interest Receivable

In a typical credit card securitization, an institution transfers to a trust a pool of receivables, as well as the rights to receive future payments of principal and interest. If a securitization transaction qualifies as a sale under Financial Accounting Standards Board Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" (FAS 140), the selling institution removes the receivables that were sold from its reported assets and continues to carry any retained interests in the transferred receivables on its balance sheet. Institutions should ensure that their accounting for securitization transactions, including the reporting of any related AIR, is in accordance with generally accepted accounting principles.

The agencies have found that many institutions continue to accrue fee and finance charge income on the investors' portion of the transferred credit card receivables even though the right to receive this income, if and when collected, has been transferred to the trust. These institutions report the

[1] The Accrued Interest Receivable represents fees and finance charges that have been accrued on receivables that the institution has securitized and sold to other investors. For example, in credit card securitizations, this Accrued Interest Receivable asset may include both finance charges billed but not yet collected and finance charges accrued but not yet billed on the securitized receivables.

rights to these accrued fees and finance charges as an asset commonly referred to as an Accrued Interest Receivable.[2] However, any of the accrued fees and finance charges that the institution collects generally must be transferred to the trust and will be used first by the trustee for the benefit of third-party investors. Only after trust expenses (such as servicing fees, investor-certificate interest, and investor-principal chargeoffs) have been paid will the trustee distribute any excess fee and finance-charge cash flow back to the seller, at which point the seller may or may not realize the full amount of its AIR asset.

Subordination of the Accrued Interest Receivable

While the selling institution retains a right to the excess cash flows generated from the fees and finance charges collected on the transferred receivables, the institution generally subordinates its right to these cash flows to the investors in the securitization. The seller's right to the excess cash flows related to the AIR asset is similar to other residual interests in securitized assets in that it serves as a credit enhancement to protect third-party investors in the securitization from credit losses. If and when cash payments on the accrued fees and finance charges are collected, they flow through the trust, where they are available to satisfy more senior obligations before any excess amount is remitted to the seller. Since investors are paid from these cash collections before the selling institution receives the amount due on its AIR, the AIR is available to absorb losses before more senior security holders.

Appropriate Regulatory Capital Treatment for Accrued Interest Receivable

Because the AIR asset as described represents a subordinated retained interest in the transferred assets, it meets the definition of a recourse exposure for risk-based capital purposes.[3] Recourse exposures such as the AIR asset require risk-based capital against the full, risk-weighted amount of the assets transferred with recourse, subject to the low-level recourse rule.[4] Further, under the final rule the agencies published in November 2001, the AIR asset also meets the definition of a "residual interest," which requires "dollar-for-dollar" capital even if that amount exceeds the full equivalent risk-based capital charge on the transferred assets.[5] Thus, the agencies expect institutions to hold risk-based capital in an amount consistent with the subordinated nature of the AIR asset and to reflect this treatment in their regulatory reports by no later than December 31, 2002. However, where supervisory concerns exist with respect to an institution's risk profile, the

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[2] Some institutions may categorize part or all of this receivable as a loan, a "due from trust" account, a retained interest in the trust, or as part of an interest-only strip receivable.

[3] This is true for the risk-based capital standards in effect prior to January 1, 2002. See, 12 CFR part 3, Appendix A, section 3(b)(1)(iii), note 14 (OCC); 12 CFR parts 208 and part 225, Appendix A, section III.D.1.g (Board); 12 CFR part 325, Appendix A, section II.D.1 (FDIC); and 12 CFR 567.6(a)(2)(i)(C) (OTS). This is also true for the risk-based capital standards in effect after December 31, 2001. See, 12 CFR Part 3, appendix A, section 4(a)(11) (2002) (OCC); 12 CFR parts 208 and 225, section III.B.3.a.x (2002) (Board); 12 CFR Part 325, appendix A, section II.B.5(a)(11) (2002) (FDIC); 12 CFR 567.6(b) (2002) (OTS).

[4] The low-level recourse rule limits the maximum risk-based capital requirement to the lesser of a banking organization's maximum contractual exposure or the full capital charge against the outstanding amount of assets transferred with recourse.

[5] For a complete description of the appropriate capital treatment for recourse, residual interests, and credit-enhancing interest-only strips, see, "Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations," 66 Fed. Reg. 59614 (November 29, 2001).

institution's primary federal supervisory agency may require it to treat the AIR asset in accordance with this advisory at an earlier date. Institutions that have been properly reflecting the AIR as a credit enhancement for risk-based capital purposes are expected to continue to do so.

Additional Information

For further information on the appropriate risk-based capital treatment for the AIR asset, please contact Amrit Sekhon at (202) 874-5211, risk expert, Capital Policy Division, at the OCC; Robert F. Storch at (202) 898-8906, accounting section chief, or Stephen G. Pfeifer at (202) 898-8904, examination specialist, Division of Supervision, at the FDIC; Tom Boemio at (202) 452-2982, senior supervisory financial analyst, Supervisory and Risk Policy, at the Board; Michael D. Solomon at (202) 906-5654, senior program manager, Capital Policy, at the OTS.