AT 10683

**FEDERAL RESERVE BANK
OF NEW YORK**

January 11, 1994

# RISK-BASED CAPITAL REQUIREMENTS

## FFIEC Recommendation Regarding Recourse Arrangements and Direct Credit Substitutes

*To the Chief Executive Officers of State Member Banks and Bank Holding Companies in the Second Federal Reserve District, and Others Concerned:*

The Federal Financial Institutions Examination Council (FFIEC) has issued the following statement concerning the regulatory treatment of recourse arrangements and direct credit substitutes:

> The Federal Financial Institutions Examination Council (FFIEC) has recommended that the four Federal banking agencies (Federal Deposit Insurance Corporation, Federal Reserve Board, Office of the Comptroller of the Currency, and the Office of Thrift Supervision) seek public comment on a Notice of Proposed Rulemaking and an Advance Notice of Proposed Rulemaking concerning the regulatory treatment of recourse arrangements and direct credit substitutes.
>
> The Notice of Proposed Rulemaking that the Examination Council is recommending to the agencies would formally define recourse and direct credit substitutes and would reduce the risk-based capital charge for low-level recourse arrangements. The recommended Advance Notice of Proposed Rulemaking sets forth a ratings-based "multi-level" approach that would base a financial institution's risk-based capital charge on its relative risk of loss in certain asset securitizations.

Enclosed is the text of the FFIEC's recommendations. Questions regarding this matter may be directed to Stephanie Martin, Financial Specialist, Bank Analysis Function (Tel. No. 212-720-1418).

CHESTER B. FELDBERG,
*Executive Vice President.*

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# FFIEC PROPOSAL

## REGARDING THE ADOPTION OF REGULATIONS CONCERNING THE TREATMENT OF RECOURSE ARRANGEMENTS AND DIRECT CREDIT SUBSTITUTES

**December 8, 1993**

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DECEMBER 8, 1993

DEPARTMENT OF THE TREASURY
OFFICE OF THE COMPTROLLER OF THE CURRENCY
12 CFR PART 3
RIN 1557-AA91
[DOCKET NO. 93-    ]

FEDERAL RESERVE SYSTEM
12 CFR PARTS 208 and 225
[DOCKET NO.    ]

FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR PART 325
[DOCKET NO.    ]

DEPARTMENT OF THE TREASURY
OFFICE OF THRIFT SUPERVISION
12 CFR PART 567
RIN 1550-AA__
[DOCKET NO.    ]

**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

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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 these 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 [Insert date 60 days after date of publication in the Federal Register.].

**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. [93- ] , 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. [ ], 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 Hoyle L. Robinson, 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

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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 9:00 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- ]. 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 1:00 p.m. until 4:00 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, (202/874-5070), Office of the Chief National Bank Examiner, David Thede, Senior Attorney, (202/874-4460), Bank Operations and Assets Division, Christopher Beshouri, Financial Economist, (202/874-5220), Economics and Evaluation; Elizabeth Milor, Financial Economist, Regulatory and Statistical Analysis (202/874-5240).
FRB: Rhoger H Pugh, Assistant Director (202/728-5883), or Thomas R. Boemio, Supervisory Financial Analyst (202/452-2982), Policy Development, Division of Banking Supervision and Regulation.
FDIC: Robert F. Storch, Chief, Accounting Section, Division of Supervision, (202/898-8906).
OTS: John F. Connolly, Program Manager for Capital Policy, (202/906-6465), Policy, Fred Phillips-Patrick, Senior Financial Economist, (202/906-7295), Policy, or Robert Kazdin, Senior Project Manager, (202/906-5759), Policy; 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.

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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

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[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.

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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.

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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 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.

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

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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 Report 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

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[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.

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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, net of any recourse liability account established (the low-level recourse rule).

### 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% 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]

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[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

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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.

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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.

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### 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, 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 <u>expected</u> losses under the recourse provision. In contrast, regulatory capital is intended to provide a cushion against <u>unexpected</u> 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

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[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.

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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 <u>any</u> 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 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

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* 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

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[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."

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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

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[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).

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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 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

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[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.

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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.

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### 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.

### 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%

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[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.

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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 must qualify under SMMEA or be guaranteed by a U.S. government sponsored agency.)

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:

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[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.

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(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.

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[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.

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(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 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

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[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.

[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.

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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.

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[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 subordinate interests will continue to be treated as recourse.

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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

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[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.

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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 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

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[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.

[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, 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.

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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.

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[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.

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### 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.

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

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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.

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[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.

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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 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.

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[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.

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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 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 and standby letters of credit. It would also continue OTS' current treatment of letters of credit.

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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

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[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.

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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. <u>See</u> 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

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[37] Because banks and thrifts are generally restricted from purchasing 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.

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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 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

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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

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[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.

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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 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

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[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.

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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

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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

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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.

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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[41] ($ 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

[41] 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.

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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.

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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[42] ($ mill) | Current Treatment for Banks[43] ($ 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

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

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

[43] See note 41.

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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

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 standalone 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.

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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 Banks[44] and Thrifts ($ mill) | Ratings Proposal ($ mill) |
|---|---|---|---|---|
| 1st | $12 | IG | $16.96 | $0.96 |
| 2nd | $200 | highest IG rating | $16 | $3.20 |
| TOTAL CAPITAL: In Dollars | | | $32.96 | $4.16 |
| As Percent Of Pool | | | 15.6% | 2.0% |

IG = Investment Grade

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%

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[44] See note 41.

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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 Banks[45] and Thrifts ($ mill) | Ratings Proposal ($ mill) |
|---|---|---|---|---|
| 1st | $12 | no IG rating | $16.96 | $12 |
| 2nd | $200 | highest IG rating* | $16 | $16 |
| TOTAL CAPITAL: In Dollars | | | $32.96 | $28 |
| As Percent Of Pool | | | 15.6% | 13.2% |

IG = Investment Grade

* 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:

[45] See note 41.

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### 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 as a whole, and 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?

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(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. 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, 1561 of 1752 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 would 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

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Y-9C; OMB No. 7100-0128). The 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 § 211.23(b) of Regulation K.

**Agency Form Number: FR Y 9-C**
**OMB Docket Number: 7100-0128**
**Frequency: Quarterly**
**Annual Reporting Hours: (to be revised)**
**Estimated Average Hours per Response: Range from (to be revised)**
**Number of Respondents: (to be revised)**

List of Subjects

12 CFR Part 3

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

12 CFR Part 208

12 CFR Part 225

12 CFR Part 325

12 CFR Part 567

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