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U.S. BANKING AGENCIES APPROVE FINAL RULE ON RECOURSE AND RESIDUALS

By Marty Rosenblatt

The FDIC, the OCC, the Fed and the OTS published substantially identical final rules revising the regulatory capital treatment of recourse, credit guarantees, residual interests in securitizations, and investments in ABS and MBS on November 29, 2001. Whenever the term “bank” is used in this synopsis, it is intended to mean both banks and thrifts in the United States.

Effective Date

The final rule is effective for transactions settled on or after January 1, 2002, with a one-year transition rule for transactions settled before that date. For transactions settled before January 1, 2002, banks can delay adoption of any provision until December 31, 2002 if adoption would be unfavorable, i.e., an increased capital requirement. On the other hand, a bank could elect to adopt any provision on December 31, 2001 if the result would be favorable, i.e., a reduced capital requirement. A reduced capital requirement could result, for example, due to the permitted netting of a deferred tax liability against a residual asset or from applying reductions for rated retained interests. An increased capital requirement could result, for example, if the amount of the retained residual interest exceeds the full risk-based-capital requirement on the assets transferred or a bank owns securities rated B and below.

Generally, a bank must maintain total capital (as defined) of at least 8% of its assets (10% for those considered well-capitalized banks), adjusted based on prescribed risk levels; and generally 50% of that capital is expected to be Tier 1 Capital (as defined).

This Synopsis Is Separated Into Three Sections Devoted To:

I. Banks Who Securitize Their Assets
II. Banks Who Invest In Third Party ABS And MBS
III. Banks Who Credit Enhance Third Party Assets

I. BANKS WHO SECURITIZE THEIR ASSETS

Dollar-for-dollar Capital Requirement

The rule replaces the existing "low-level recourse" rule with a so-called "dollar-for-dollar" capital rule. In other words, a bank must generally maintain risk-based capital equal to the "face amount" of the residual interest that is retained on the balance sheet (net of any existing associated deferred tax liabilities) *without regard* to whether such amount is less than or greater than the full risk-based capital requirement for the assets securitized. Thus, the capital requirement for residual interests is not limited by the 8% capital in place under the current risk-based capital regime, but still can be less than the 8% of assets whenever the retained residual is less than 8% of the transferred assets.

Some definitions are in order:

1. *Residual Interest* means any on-balance sheet asset that represents a retained beneficial interest, in a securitization accounted for as a sale, and that exposes the bank to ANY credit risk directly or indirectly associated with the transferred asset that exceeds a *pro rata* share of that bank's claim on the asset. Residual interests include "credit-enhancing interest-only strips"{see below}, spread accounts, cash collateral accounts, retained subordinated interests and other forms of over-collateralization. The agencies also listed accrued but uncollected interest on transferred assets (presumably in revolving credit card securitizations) that, when collected, will be available to serve in a credit-enhancing capacity, as another example of a residual interest. Residual interests generally do not include interests purchased from a third party other than purchased credit-enhancing interest-only strips (defined below). {Query: Would a second-dollar or third-dollar loss position be considered to expose the bank to more than a *pro rata* share of losses? Yes, if any other interests are senior to the retained interest, the regulators would say the retained interest would be a residual interest; however, if rated, it might be eligible for favorable capital treatment.}

2. *Face Amount* means (1) the amortized cost of an asset, if not held in a trading account (e.g., accounted for as held-to-maturity [if permitted] or available-for-sale), or (2) the fair value of the asset if held in a trading account. Therefore, although the balance sheet carrying value of an asset that is carried as available-for-sale might have been increased or decreased for unrealized appreciation or depreciation, it is the amortized cost amount that should be used in the calculation of risk-based capital.

Deferred Tax Liabilities

In order to reduce the capital requirement for deferred tax liabilities, the liability must be on the balance sheet and specifically identifiable with the residual interest. For example, if a securitization were accounted for as a sale for GAAP but treated as debt-for-tax, and gain on sale was recognized in an amount approximating the present value of a retained I/O strip, then it is likely that deferred taxes would have been provided on that timing difference, which will reverse over the life of the securitization. On the other hand, if the residual interest were represented by a deposit into a cash collateral account, it is unlikely that there would be any associated deferred taxes.

Permitted Reductions For Rated Retained Interests

Certain rated residual interests (with the exception of "credit-enhancing interest-only strips") are not subjected to the full dollar-for-dollar capital treatment. The following table presents the manner in which the ratings-based approach would typically be applied, for example, to a "second-dollar" loss position.

Example Rating	Risk-Weight	Capital Required for each $1 of Investment
a) *Investment Grade:*		
AAA or AA*	20%	1.6 cents
A*	50%	4 cents
BBB	100%	8 cents
b) *One Category Below:*		
BB	200%	16 cents
c) B and below, and all Unrated	Not eligible for reduction	100 cents

** IOs and POs are not eligible for less than 100% weighting regardless of ratings.*

Keep in mind that a 200% risk-weight translates to a much lower capital charge than dollar-for-dollar. The capital requirement for a position is computed by multiplying the face amount of the position by the appropriate risk weight determined from the table. Thus, under the new rule, securities rated BB require capital equal to 200% x 8% {16%} of the face amount, whereas, securities B and below or unrated require capital equal to 100% of the face amount (dollar-for-dollar capital).

Only one rating is required if there is a reasonable expectation that in the near future either (1) the position may be traded or (2) the position may be used in a secured loan or repo transaction in which a third party relies on the rating. Otherwise, to qualify for the ratings-based approach, the position must be rated by more than one rating agency, the ratings must be the equivalent of BB or better by all rating agencies providing a rating, the ratings must be publicly available, and the ratings must be based on the same criteria used to rate securities that are traded. If the ratings are different, the lowest rating will determine the risk-weight.

In the absence of external ratings, the regulators have decided for the present not to allow banks to use internal ratings, program ratings or computer programs to apply a risk-based

capital treatment more favorable than a dollar-for-dollar capital requirement to "residual interests," although such methodology will be allowed for other types of exposures.

If a bank does not retain any residual interests but provides other forms of recourse on the transaction, then a "credit-equivalent amount" for the recourse obligation is computed. It is the **full amount** of the credit-enhanced assets for which the bank retains or assumes credit risk, *subject to* the low-level exposure rule. Thus, a bank that extends a partial guaranty of, for example, the first five percent of loss on a securitization, must maintain capital equal to 5% of the transferred assets. If the guaranty covered the first 10% of loss, then the risk-based capital could be limited to 8% of the transferred assets. Examples of recourse include credit-enhancing reps and warranties, loan servicing arrangements where the bank is responsible for losses, assets sold under an agreement to repurchase, and credit derivative contracts under which the bank retains more than its *pro rata* share of credit risk on transferred assets.

If a bank securitizes assets in a sale and provides credit enhancement in the form of both the retention of residual interests and retention of other recourse obligations, (e.g.,writing a limited guarantee regarding the performance of the assets or entering into a credit derivative), then the capital is computed as the *greater* of (1) the risk-based capital requirement for the residual interests or (2) the full risk-based capital requirement for the transferred assets.

If a bank sells a residual interest to a third-party but writes a credit derivative to cover the credit risk associated with that asset, the selling bank must continue to risk-weight, and hold capital against, that asset as a residual as if the asset had not been sold. The same holds true if a bank transfers the risk on a residual interest through guarantees or other credit risk mitigation techniques, and then reassumes this risk in any form.

Some banks might consider securitizing pools of whole loans and retaining all or substantially all of the resulting securities. Depending on the risk-weighting of the pool (first-lien one-to-four-family residential mortgage loans are risk-weighted at 50%, not 100%) and how many A or better rated securities can be created, a bank might be able to reduce the overall capital requirements on the pool and increase liquidity. For the transaction to be recognized for accounting purposes (which is essential to the capital treatment), either (1) at least 10% of the value of the transferred assets must be sold to third parties in the form of beneficial interests; or (2) the transaction must be a "guaranteed mortgage securitization" as defined in FASB 140.

Concentration Limit For Certain Residual Interests

The rule imposes a concentration limit on "credit-enhancing interest-only strips (CEIOs)", whether retained or purchased, to 25% of Tier 1 Capital (Core Capital for Thrifts) as adjusted for any other other disallowed items. For regulatory capital purposes only, any amount of CEIOs that exceeds the 25% limit will be deducted from Tier 1 capital. CEIOs that are not deducted from Tier 1 capital, along with all other residual interests are subject to the dollar-for-dollar requirements, as described above.

Some more definitions are in order:

3. *A Credit-Enhancing Interest-Only Strip* means an on-balance sheet asset that (1) represents the contractual right to receive some or all of the interest due on transferred assets and (2) exposes the bank to credit risk that exceeds its *pro rata* claim on the underlying assets. Thus, CEIOs include any balance sheet asset that represents the contractual right to receive some or all of the remaining interest cash flow generated from assets that have been transferred to an SPE, after taking into account trustee and other administrative expenses, interest payments to investors, servicing fees, and reimbursements to investors for losses attributable to the beneficial interests they hold. An instrument with these characteristics will still be considered a CEIO even if it is entitled to some principal.
4. *Tier 1(Core) Capital* must equal or exceed 4% of risk-weighted assets (total capital must equal or exceed 8%) and is comprised of common stockholders' equity, noncumulative perpetual preferred stock, plus minority interest in subsidiaries LESS most intangible assets as well as deductions for the following types of assets when they exceed the relevant capital limitations (e.g., 25% of Tier 1 for CEIOs): certain mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships, CEIOs, and deferred tax assets.

The following example illustrates the concentration calculation:

> A bank has $100 in purchased and retained CEIOs on its balance sheet and Tier 1 capital of $320 (before any disallowed servicing assets, purchased credit card relationships and deferred tax assets). The bank would multiply the Tier 1 capital of $320 by 25%, which is $80. The amount of CEIOs that exceed the concentration limit, in this case, $20, is deducted from Tier 1 capital. The remaining $80 is then subject to the dollar-for-dollar capital charge. The $20 deducted from Tier 1 capital, plus the $80 in total risk-based capital required, equals $100, the balance sheet amount of the CEIOs. Banks may apply a net-of-deferred-tax approach on any CEIOs that have been disallowed from Tier 1, as well as to the remaining residual interests subject to the risk-based-capital rule.

Securitizations Accounted For As Financings

When a securitization is accounted for as a financing, no gain is recognized or capital created from an accounting standpoint, which serves to mitigate some of the regulators' concerns. The agencies, however, have said that they will monitor securitization transactions that are accounted for as financings and will factor into the bank's capital adequacy determination the risk exposures being assumed or retained in connection with the transaction.

Additional Authority

The agencies have said that they intend to apply the final rule to the substance, rather than the form, of a securitization transaction. The agencies retain the authority to exercise discretion to ensure that banks, as they develop novel financial assets, will be treated appropriately under the regulatory capital standards. Accordingly, they have the right to assign risk positions in securitizations to appropriate risk categories on a case-by-case basis if the credit rating of the risk position is determined to be inappropriate.

Clean-up Calls

The agencies have had longstanding concerns that a bank may implicitly undertake a credit-enhancing position by exercising a clean-up call option when the credit quality of the securitized loans is deteriorating. An excessively large clean-up call facilitates a securitization servicer's ability to take investors out of a pool to protect them from absorbing credit losses and, thus, may indicate that the servicer has retained or assumed the credit risk on the underlying pool of loans.

Under the final rule, an agreement that permits a bank that is a servicer or an affiliate of the servicer to elect to purchase loans in a pool is not recourse or a direct credit substitute if the agreement permits the bank to purchase the remaining loans in a pool when the balance of those loans is equal to or less than 10% of the original pool balance. {Query: Could the 10% relate to the outstanding balance of the bonds, rather than the collateral, as some optional termination provisions are written?} However, an agreement that permits the remaining loans to be repurchased when their balance is greater than 10% of the original pool balance is considered to be recourse or a direct credit substitute. {Query: Could one argue that the portion considered to be recourse should be limited to the excess over 10%?}

Further, to minimize the potential for using such a feature as a means of providing support for a troubled portfolio, the agencies say that a bank that exercises a call should not repurchase any loans in the pool that are 30 days or more past due. Alternatively, the bank should repurchase the loans at the lower of their estimated fair value or their par value plus accrued interest. Regardless of the size of the clean-up call, the agencies will closely scrutinize any transaction whereby the banking organization repurchases deteriorating assets for an amount greater than a reasonable estimate of their fair value and will take action accordingly. {Query: Would their concerns be mitigated when the bank holds the first-loss position and has provided dollar-for-dollar capital?}

Servicer Advances

Cash advances made by residential mortgage loan servicers to ensure an uninterrupted flow of payments to investors are specifically excluded from the definition of recourse, provided that the residential mortgage loan servicer is entitled to reimbursement for any significant advances and this reimbursement is not subordinate to other claims. Before deciding to advance, the bank, as servicer, is expected to make an independent credit assessment of the likelihood of repayment of the servicer advance and should only make such an advance if prudent lending standards are met. {Query: What about asset types other than residential mortgage loans?}

Interaction With Market Risk Rule

Some large, sophisticated banks (but not thrifts) are allowed to apply the "market risk rules." For banks that comply with the market risk rules, positions in the trading book arising from securitizations should be treated for risk-based capital purposes in accordance with those rules. However, they are still subject to the 25% concentration limit for CEIOs.

Quarterly Valuations

The rule requires that the fair value of servicing assets, purchased credit card relationships and CEIOs be updated at least quarterly and include adjustments for any significant changes in assumptions. The regulators may require independent fair value estimates where they deem it appropriate.

II. BANKS WHO INVEST IN ABCP,ABS,CDOs,CMBS, and MBS

Flight to Quality?

Currently, all investments in third party ABS and MBS, other than agency securities, are assigned a 100% risk-weight. Now, banks will be able to reduce the capital on positions rated A or better, but will have increased requirements on positions rated BB or below. ABS and MBS extends to CMBS and CDOs, although further research may be needed on certain synthetic CDOs. The approach also applies to short-term instruments like asset-backed commercial paper.

Risk-weights for Externally Rated Positions:

Example Rating	Risk-Weight	Capital Required for each $1 of Investment
Long-Term Rating Categories		
a) *Investment Grade:*		
AAA or AA*	20%	1.6 cents
A*	50%	4 cents
BBB	100%	8 cents
b) *One Category Below:*		
BB	200%	16 cents
c) B and below, and all Unrated	Not eligible for reduction	100 cents
Short-Term Rating Categories - all Investment Grade		
A-1, P-1	20%	1.6 cents
A-2, P-2	50%	4 cents
A-3, P-3	100%	8 cents

*IOs and POs are not eligible for less than 100% risk weighting regardless of rating.

The risk-weights are applied against (1) the amortized cost of securities classified as held-to-maturity or available-for-sale and (2) the fair value of securities classified as trading.

Only one rating is required if there is a reasonable expectation that in the near future either (1) the position may be traded or (2) the position may be used in a secured loan or repo transaction in which a third party relies on the rating. Otherwise, to qualify for the ratings-based approach, the position must be rated by more than one rating agency, the ratings must be the equivalent of BB or better by all rating agencies providing a rating, the ratings must be publicly available, and the ratings must be based on the same criteria used to rate securities that are traded. If the ratings are different, the lowest rating will determine the risk-weight.

For an unrated purchased subordinated security, a bank must calculate risk-weighted assets using the amount of the subordinated security and the full amount of the assets it supports, i.e., all the more senior positions in the structure.

For a purchased credit-enhancing interest-only strip, a bank must maintain dollar-for-dollar capital against the book value of the position.

III. BANKS WHO CREDIT ENHANCE THIRD PARTY ASSETS

The risk-weighted amounts for all off-balance sheet exposures are determined by a two-step process:

First, the full amount of the credit-enhanced assets for which the bank directly or indirectly assumes credit risk is known as the "Credit Equivalent Amount," not the maximum amount of the loss exposure. For example, if a bank extends a financial standby letter of credit that absorbs the first 5% of loss on a pool of assets, the bank must first calculate capital at the appropriate risk-weight against the full amount of the assets being supported (see "Low-level exposure rule" below).

Second, the *credit equivalent amount* is assigned to a risk category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral.

Low-Level Exposure Rule:

If the maximum exposure to loss assumed by the bank is less than the effective risk-based capital requirement for the credit-enhanced assets, the risk-based capital is limited to the bank's maximum contractual exposure, less any recourse liability established in accordance with GAAP.

Some more definitions are in order:

5. *A Credit-Derivative* means a contract that allows one party (the protection purchaser) to transfer the credit risk of an asset or off-balance sheet credit exposure to another party (the protection provider). The value of a credit derivative is dependent, at least in part, on the credit performance of a "reference asset".

6. *A Direct Credit Substitute* means an arrangement in which a bank assumes credit risk with respect to an asset that it was not previously exposed to. More specifically, it is an arrangement in which a bank assumes, in form or in substance, credit risk directly or indirectly associated with an on- or off-balance sheet asset or exposure that was not previously owned by the bank (third-party asset) and the risk assumed by the bank exceeds the *pro rata* share of the bank's interest in the third-party asset. An arrangement in which a bank has any credit risk without having any claim on the asset is always a direct credit substitute, including, but not limited to:

   (a) financial standby letters of credit

   (b) guarantees and surety arrangements

   (c) credit derivatives

   (d) loans or lines of credit that provide credit enhancement for the financial obligations of an account party