RESCINDED

#344

Office of Thrift Supervision
Department of the Treasury

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Typographical error in Example A on page 2 was corrected on April 20, 2010

Additional typographical error in Example A on page 2 was corrected on May 6, 2010

Outdated - See OCC 2015-38

April 16, 2010

MEMORANDUM FOR: **CHIEF EXECUTIVE OFFICERS**

FROM: Thomas A. Barnes, Deputy Director
Examinations, Supervision, and Consumer Protection

SUBJECT: Risk Weighting of Early Default Provisions

OTS risk-based capital regulations define recourse as a savings association's (SA) retention of credit risk, directly or indirectly associated with assets sold, that exceeds a pro rata share of that SA's claim on the assets. Where there is recourse, an SA must hold capital for the assets as if they were still carried on the SA's books.

Mortgage loan sales often contain provisions categorized as "representations and warranties" that meet the recourse definition. Conversely, other provisions in mortgage loan sales are excluded from the definition of recourse. For example, early default clauses and similar warranties (including premium refund clauses) that, for a period not to exceed 120 days from the date of transfer, permit the return of qualifying mortgage loans are *not* considered recourse.

When an early default clause falls within the 120-day exemption period, the SA is not, at the outset, required to hold risk-based capital. If an early default clause is actually triggered and, as a result, loans may be returned to the SA, then, at notice of the triggering event, the SA must hold risk-based capital in anticipation of the return of the loan. If the SA is unable to track which loans it might be required to repurchase, it must hold capital against all sold loans until such time as it can make a determination about potential exposure (i.e., through the period covered by the early default provision).

When an early default clause extends beyond 120 days, the SA must hold risk-based capital from the date of transfer of the loans until the SA can determine that the warranty period has expired and no (or no additional) sold loans have defaulted. However, when an early default clause is combined with a *second* representation or warranty, often referred to as a "double trigger," the SA must make two determinations:

1. First, the SA must determine whether the event of default occurs within or beyond the 120-day period. If the event of default occurs *beyond the 120 day period*, the loan meets the recourse definition and the SA must hold risk-based capital as if that loan was still carried on the SA's books.

2. If the event of default occurs *within the 120 day period*, the SA must determine whether the second trigger places a limit on recourse liability. Although the second trigger may extend the total period beyond 120 days**,** if that second trigger *limits recourse liability, and therefore credit risk*, the SA is not required to hold risk-based capital from the date of transfer. Again, the SA must be able to demonstrate to supervisory staff that the SA can properly track whether an event of default has occurred.

The SA should also review clauses governing applicable notification periods when evaluating whether a double trigger clause limits recourse liability. Some notice provisions simply provide an administrative mechanism for informing the seller SA that a loan has defaulted and/or is being returned for repurchasing. Other notification provisions may operate to extend the period to return a loan that goes beyond a reasonable administrative period. The SA will bear the burden of demonstrating that particular notice provisions are administrative and limit recourse liability.

The following examples and the timeline diagrams in the attachment should also help illustrate the appropriate capital treatment. Early default clauses (EDC) can be more complex than these examples and should be analyzed on a case-by-case basis to determine whether the double trigger mitigates risk of loss for the SA.

- **Example A – EDC: Default on any of the first four payments and the loan fails to cure within 120 days after the date of default**

  Because the events of default are *within the 120-day exemption period*, recourse liability does not exist until one of the first four payments defaults. If any of the first four payments default, recourse is triggered and the SA must hold risk-based capital in anticipation of the return of the loan. If the borrower cures the default and the loan can no longer be returned to the seller, the SA is no longer required to hold risk-based capital.

- **Example B – EDC: First payment default followed by a 90-day delinquency in the first 12 months from the date of transfer**

  Because the first trigger is within the 120-day exemption period, recourse liability does not exist until the first payment defaults. For loans that default, however, the SA must hold risk-based capital *until the second trigger no longer applies*, i.e., until the SA can demonstrate that none of the payments due in the first year are 90-days delinquent.

- **Example C – EDC: First payment default or by a 90-day delinquency in the first 12 months from the date of transfer**

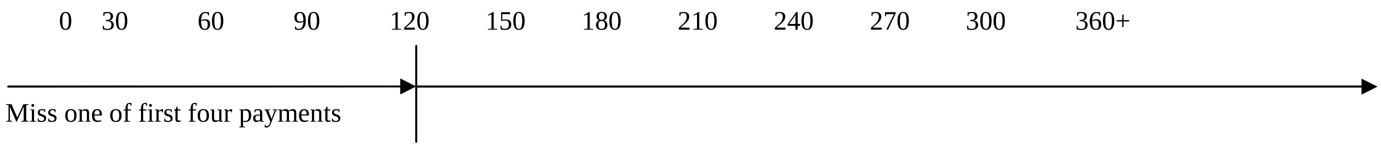
Recourse liability exists and the SA must hold risk-based capital for the first 12 months from the date of transfer. Although there are two triggers listed, the second trigger does not place a limit on recourse liability. Instead, it only operates to extend recourse liability beyond the 120-day period.

Should you have any questions regarding the above, please contact Teresa Scott (202) 906-6478 (teresa.scott@ots.treas.gov).

Attachment

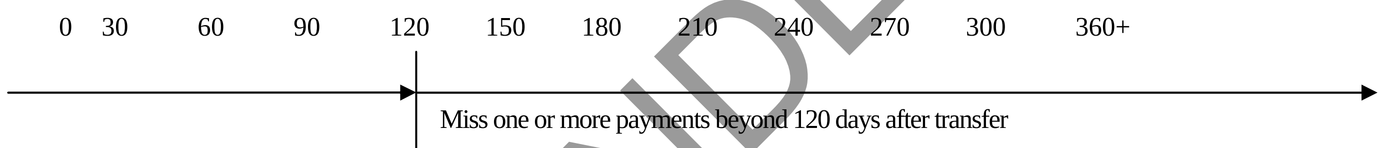
ATTACHMENT
EARLY DEFAULT CLAUSE (EDC) EXAMPLES

Single Trigger
(EDC: Miss one of first four payments)



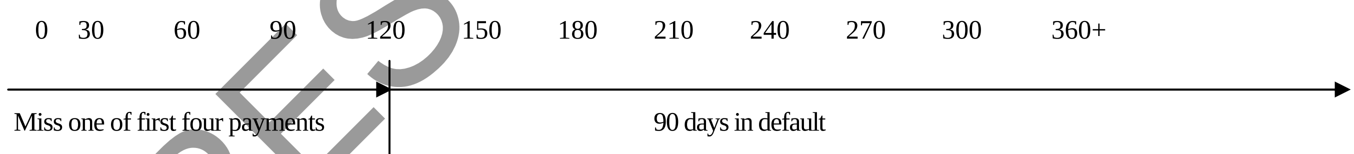
Not recourse: Hold no capital from date of transfer. *However*, if trigger event occurs, begin to hold capital in anticipation of return of loan.

Single Trigger
(EDC: Miss one or more payments beyond 120 days after transfer)



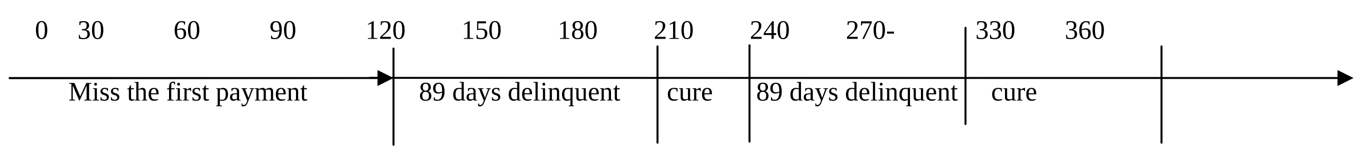
Recourse: Hold capital from date of origination.

Double Trigger
(EDC: Miss one of first four payments followed by 90-day delinquency within first 12 months from date of transfer)



Not recourse. Both first trigger (default of any of first four payments) **<u>and</u>** second trigger (90 day delinquency within first 12 months from transfer) must be met before buyer can demand repurchase from seller. ***However***, if any of first four payments are missed, must hold recourse until second trigger period expires.

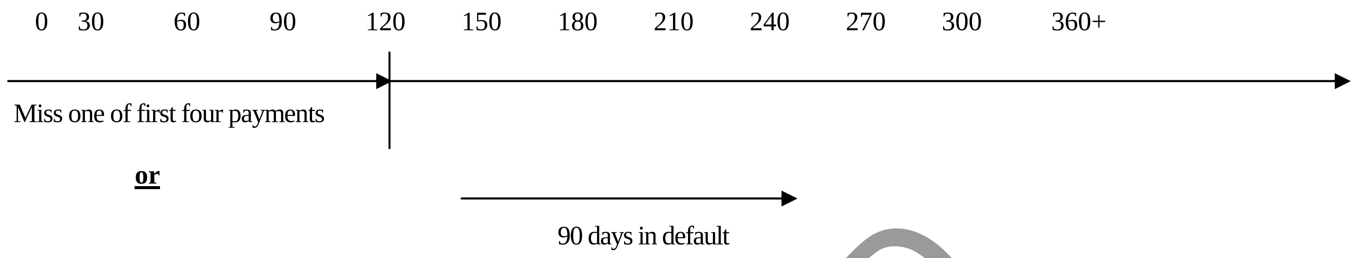
Double Trigger
(EDC: Miss first payment, and 90 days delinquent during first twelve months)



Not recourse: Both first trigger (miss first payment) **<u>and</u>** second trigger (90 days in default within first 12 months) must be met before buyer can demand repurchase from seller. ***However***, if first payment is missed, must hold recourse until second trigger period expires. Note: Loan can go into default more than once during 12-month period as long as that default lasts no more than 90 days before buyer can require repurchase of loan.

Double Trigger

(EDC: Miss first payment, or 90 days delinquent during first twelve months)



Recourse: Although there are two triggers, the second trigger does not place a limit on recourse liability.