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Part II

Department of the Treasury

Office of the Comptroller of the Currency
Office of Thrift Supervision

Federal Reserve System

Federal Deposit Insurance Corporation

12 CFR Parts 3, 208, 225, 325 and 567

Risk-Based Capital Standards; Recourse and Direct Credit Substitutes; Proposed Rule

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Part 3

[Docket No. 00–06]

RIN 1557–AB14

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225

[Regulations H and Y; Docket No. R–1055]

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 325

RIN 3064–AB31

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

12 CFR Part 567

[Docket No. 2000–15]

RIN 1550–AB11

Risk-Based Capital Standards; Recourse and Direct Credit Substitutes

AGENCIES: Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and Office of Thrift Supervision, Treasury.

ACTION: Joint notice of proposed rulemaking.

SUMMARY: The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the agencies) are proposing changes to their risk-based capital standards to address the regulatory capital treatment of recourse obligations and direct credit substitutes that expose banks, bank holding companies, and thrifts (collectively, banking organizations) to credit risk. The proposal treats recourse obligations and direct credit substitutes more consistently than under the agencies' current risk-based capital standards. In addition, the agencies would use credit ratings and certain alternative approaches to match the risk-based capital requirement more closely to a banking organization's relative risk of loss in asset securitizations. The proposal also requires the sponsor of a revolving credit securitization that involves an early amortization feature to hold capital against the amount of assets under management, *i.e.* the off-balance sheet securitized receivables.

This proposal is intended to result in more consistent treatment of recourse obligations and similar transactions among the agencies, more consistent risk-based capital treatment for certain types of transactions involving similar risk, and capital requirements that more closely reflect a banking organization's relative exposure to credit risk.

DATES: Your comments must be received by June 7, 2000.

ADDRESSES: Comments should be directed to:

OCC: You may send comments electronically to regs.comments@occ.treas.gov or by mail to Docket No. 00–06, Communications Division, Third Floor, Office of the Comptroller of the Currency, 250 E Street, SW, Washington, DC 20219. In addition, you may send comments by facsimile transmission to (202) 874–5274. You can inspect and photocopy comments at that address.

Board: Comments, which should refer to Docket No. R–1055, may be mailed to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW, Washington, DC 20551. Comments may also be delivered to Room B–2222 of the Eccles Building between 8:45 a.m. and 5:15 p.m. weekdays, or to the guard station in the Eccles Building courtyard on 20th Street between Constitution Avenue and C Street, NW, at any time. Comments may be inspected in Room MP–500 of the Martin Building between 9 a.m. and 5 p.m. weekdays, except as provided in 12 CFR 261.8 of the Board's Rules Regarding Availability of Information.

FDIC: Written comments should be addressed to Robert E. Feldman, Executive Secretary, Attention: Comments/OES, Federal Deposit Insurance Corporation, 550 17th Street, NW, Washington, DC 20429. Comments may be hand delivered to the guard station at the rear of the 550 17th Street Building (located on F Street), on business days between 7 a.m. and 5 p.m. (Fax number: (202) 898–3838; Internet address: comments@fdic.gov). Comments may be inspected and photocopied in the FDIC Public Information Center, Room 100, 801 17th Street, NW, Washington, DC, between 9 a.m. and 4:30 p.m. on business days.

OTS: Send comments to Manager, Dissemination Branch, Records Management and Information Policy, Office of Thrift Supervision, 1700 G Street, NW, Washington, DC 20552, Attention Docket No. 2000–15. These submissions may be hand-delivered to 1700 G Street, NW, from 9 a.m. to 5 p.m. on business days or may be sent by facsimile transmission to FAX number (202) 906–7755; or by e-mail: public.info@ots.treas.gov. Those commenting by e-mail should include their name and telephone number. Comments will be available for inspection at 1700 G Street, NW, from 9 to 4 p.m. on business days.

FOR FURTHER INFORMATION CONTACT:

OCC: Roger Tufts, Senior Economic Advisor or Amrit Sekhon, Risk Specialist, Capital Policy Division, (202) 874–5070; Laura Goldman, Senior Attorney, Legislative and Regulatory Activities Division, (202) 874–5090, Office of the Comptroller of the Currency, 250 E Street, SW, Washington, DC 20219.

Board: Thomas R. Boemio, Senior Supervisory Financial Analyst, (202) 452–2982, or Norah Barger, Assistant Director (202) 452–2402, Division of Banking Supervision and Regulation. For the hearing impaired *only,* Telecommunication Device for the Deaf (TDD), Diane Jenkins, (202) 452–3544, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW, Washington, DC 20551.

FDIC: Robert F. Storch, Chief, Accounting Section, Division of Supervision, (202) 898–8906; or Jamey Basham, Counsel, Legal Division, (202) 898–7265, Federal Deposit Insurance Corporation, 550 17th Street, NW, Washington, DC 20429.

OTS: Michael D. Solomon, Senior Program Manager for Capital Policy, Supervision Policy, (202) 906–5654; or Karen Osterloh, Assistant Chief Counsel (202) 906–6639, Office of Thrift Supervision, 1700 G Street, NW, Washington, DC 20552.

SUPPLEMENTARY INFORMATION:

I. Introduction

The agencies are proposing to amend their risk-based capital standards to change the treatment of certain recourse obligations, direct credit substitutes, and securitized transactions that expose banking organizations to credit risk. This proposal amends the agencies' risk-based capital standards to align more closely the risk-based capital treatment of recourse obligations and direct credit substitutes and to vary the capital requirements for positions in securitized transactions (and certain other credit exposures) according to their relative risk. The proposal also requires the sponsor of a revolving credit securitization that involves an early amortization feature to hold capital against the amount of assets under management in that securitization.

This proposal builds on the agencies' earlier work with respect to the appropriate risk-based capital treatment for recourse obligations and direct credit substitutes. On May 25, 1994, the agencies published in the **Federal Register** a proposal to reduce the capital requirement for banks for low-level recourse transactions, to treat first-loss (but not second-loss) direct credit substitutes like recourse, and to implement definitions of ''recourse,'' ''direct credit substitute,'' and related terms. 59 FR 27116 (May 25, 1994) (the 1994 Notice). The 1994 Notice also contained, in an advance notice of proposed rulemaking, a proposal to use credit ratings to determine the capital treatment of certain recourse obligations and direct credit substitutes. The OCC, the Board, and the FDIC subsequently implemented the capital reduction for low-level recourse transactions, thereby satisfying the requirements of section 350 of the Riegle Community Development and Regulatory Improvement Act, Public Law 103–325, sec. 350, 108 Stat. 2160, 2242 (1994) (CDRI Act).[1] The OTS risk-based capital regulation already included the low-level recourse treatment required by the statute.[2] The agencies did not issue a final regulation on the remaining elements of the 1994 Notice.

On November 5, 1997, the agencies published another notice of proposed rulemaking. 62 FR 59943 (1997 Proposal). In the 1997 Proposal, the agencies proposed to use credit ratings from nationally recognized statistical rating organizations to determine the capital requirement for recourse obligations, direct credit substitutes, and senior asset-backed securities. Additionally, the 1997 Proposal requested comment on a series of options and alternatives to supplement or replace the ratings-based approach.

In June 1999, the Basel Committee on Banking Supervision issued a consultative paper, ''A New Capital Adequacy Framework, that sets forth possible revisions to the 1988 Basel Accord.[3] The Basel consultative paper discusses potential modifications to the current capital standards, including the capital treatment of securitizations. The suggested changes in the Basel consultative paper move in the same direction as this proposal by looking to external credit ratings issued by qualifying external credit assessment institutions as a basis for determining the credit quality and the resulting capital treatment of securitizations.

II. Background

A. Asset Securitization

Asset securitization is the process by which loans or other credit exposures are pooled and reconstituted into securities, with one or more classes or positions, that may then be sold. Securitization[4] provides an efficient mechanism for banking organizations to buy and sell loan assets or credit exposures and thereby to make them more liquid.

Securitizations typically carve up the risk of credit losses from the underlying assets and distribute it to different parties. The ''first dollar,'' or subordinate, loss position is first to absorb credit losses; the most ''senior'' investor position is last; and there may be one or more loss positions in between (''second dollar'' loss positions). Each loss position functions as a credit enhancement for the more senior loss positions in the structure.

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

A seller may provide this credit enhancement itself through recourse arrangements. As defined in this proposal, ''recourse'' refers to the risk of credit loss that a banking organization retains in connection with the transfer of its assets. Banking organizations have long provided recourse in connection with sales of whole loans or loan participations; today, recourse arrangements frequently are associated with asset securitization programs.

A seller may also arrange for a third party to provide credit enhancement[5] in an asset securitization. If the third-party enhancement is provided by another banking organization, that organization assumes some portion of the assets' credit risk. In this proposal, all forms of third-party enhancements, *i.e.*, all arrangements in which a banking organization assumes risk of credit loss from third-party assets or other claims that it has not transferred, are referred to as ''direct credit substitutes.'' The economic substance of a banking organization's risk of credit loss from providing a direct credit substitute can be identical to its risk of credit loss from transferring an asset with recourse.

Depending on the type of securitization transaction, the sponsor of a securitization may provide a portion of the total credit enhancement internally, as part of the securitization structure, through the use of spread accounts, overcollateralization, retained subordinated interests, or other similar forms of on-balance sheet assets. When these or other types of internal enhancements are provided, the enhancements are considered a form of recourse for risk-based capital purposes. Many asset securitizations use a combination of internal enhancement, recourse, and third-party enhancement to protect investors from risk of credit loss.

B. Risk Management of Exposures Arising From Securitization Activities

While asset securitization can enhance both credit availability and a banking organization's profitability, managing the risks associated with this activity can pose significant challenges. This is because the risks involved, while not new to banking organizations, may be less obvious and more complex than the risks of traditional lending. Specifically, securitization can involve credit, liquidity, operational, legal, and reputational risks in concentrations and forms that may not be fully recognized by management or adequately incorporated into a banking organization's risk management systems.

The risk-based capital treatment described in this proposal provides one important way of addressing the credit risk presented by securitization activities, but a banking organization's compliance with capital standards should be complemented by effective risk management strategies. The agencies expect that banking organizations will identify, measure, monitor and control the risks of their securitization activities (including

[1] *See* 60 FR 17986 (April 10, 1995) (OCC); 60 FR 8177 (February 13, 1995) (Board); 60 FR 15858 (March 28, 1995) (FDIC).

[2] *See* 60 FR 45618 (August 31, 1995.)

[3] International Convergence of Capital Measurement and Capital Standards (July 1988).

[4] For purposes of this discussion, references to ''securitization'' also include structured finance transactions or programs that generally create stratified credit risk positions, which may or may not be in the form of a security, whose performance is dependent upon a pool of loans or other credit exposures.

[5] As used in this proposal, the terms ''credit enhancement'' and ''enhancement'' refer to both recourse arrangements and direct credit substitutes.

synthetic securitizations[6] using credit derivatives) and explicitly incorporate the full range of risks into their risk management systems. Management is responsible for having adequate policies and procedures in place to ensure that the economic substance of their risks is fully recognized and appropriately managed. Banking organizations should be able to measure and manage their risk exposure from risk positions in the securitizations, either retained or acquired, and should be able to assess the credit quality of the retained residual portfolio after the transfer of assets in a securitization transaction. The formality and sophistication with which the risks of these activities are incorporated into a banking organization's risk management system should be commensurate with the nature and volume of its securitization activities. Banking organizations with significant securitization activities, no matter what the size of their on-balance sheet assets, are expected to have more elaborate and formal approaches to manage the risks. Failure to understand the risks inherent in securitization activities and to incorporate them into risk management systems and internal capital allocations may constitute an unsafe or unsound banking practice.

Banking organizations must have adequate systems that evaluate the effect of securitization transactions on the banking organization's risk profile and capital adequacy. Based on the complexity of transactions, these systems should be capable of differentiating between the nature and quality of the risk exposures transferred versus those that the banking organization retains. Adequate management systems usually:

• Have an internal system for grading credit risk exposures, including: (1) Adequate differentiation of risk among risk grades; (2) adequate controls to ensure the objectivity and consistency of the rating process; and (3) analysis or evidence supporting the accuracy or appropriateness of the risk-grading system.[7]

• Evaluate the effect of the transaction on the nature and distribution of the banking book exposures that have not been transferred in connection with securitization. This analysis should include a comparison of the banking book's risk profile before and after the transaction, including the mix of exposures by risk grade and by business or economic sector. The analysis should also include identification of any concentrations of credit risk.

• Perform rigorous, forward-looking stress testing[8] on exposures that have not been transferred (that is, loans and commitments remaining in the banking book), transferred exposures, and exposures retained to facilitate transfers (that is, credit enhancements).

• Have an internal economic capital allocation methodology that provides the banking organization will have adequate capitalization to meet a specific probability that it will not become insolvent if unexpected credit losses occur and that readjusts, as necessary, the sponsoring bank's internal economic capital requirements to take into account the effect of the securitization transactions.

Banking organizations should ensure that their capital positions are sufficiently strong to support all of the risks associated with these activities on a fully consolidated basis and should maintain adequate capital in all affiliated entities engaged in these activities.

C. Current Risk-Based Capital Treatment 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 current rules of the OCC, Board, and FDIC (the banking agencies) are also not entirely consistent with those of the OTS.

1. Recourse

The agencies' risk-based capital guidelines prescribe a single treatment for assets transferred with recourse, regardless of whether the transaction is reported as a financing or a sale of assets in a bank's Consolidated Reports of Condition and Income (Call Report), a bank holding company's FR Y–9 reports, or a thrift's Thrift Financial Report.[9] For a transaction reported as a financing, the transferred assets remain on the balance sheet and are risk-weighted. For a transaction reported as a sale, the entire outstanding amount of the assets sold (not just the contractual amount of the recourse obligation) is converted into an on-balance sheet credit equivalent amount using a 100% credit conversion factor. This credit equivalent amount (less any applicable recourse liability account recorded on the balance sheet) is then risk-weighted.[10] If the seller's balance sheet includes as an asset any retained interest in the assets sold, the retained interest is not risk-weighted separately. Thus, regardless of the method used to account for the transfer, risk-based capital is held against the full, risk-weighted amount of the transferred assets, although the transaction is subject to the low-level recourse rule, which limits the maximum risk-based capital requirement to the banking organization's maximum contractual exposure.[11]

For leverage capital ratio purposes, if a transfer with recourse is reported as a financing, the transferred assets remain on the transferring banking organization's balance sheet and the banking organization must hold leverage capital against these assets. If a transfer with recourse is reported as a sale, the assets sold do not remain on the selling

[6] "Synthetic securitization" refers to the bundling of credit risk associated with on-balance sheet assets and off-balance sheet items for subsequent sale into the market.

[7] In this regard, the agencies note that one increasingly important component of the systems for controlling credit risk at larger banking organizations is the identification of the gradations in credit risk among their business loans and the assignment of internal credit risk ratings to loans that correspond to these gradations. The agencies believe that the use of such an internal rating process is appropriate—indeed, necessary—for sound risk management at large banking organizations. In particular, those banking organizations with significant involvement in securitization activities should have relatively elaborate and formal approaches for assessing and managing the associated credit risk.

[8] Stress testing usually involves identifying possible events or changes in market behavior that could have unfavorable effects on an banking organization and assessing the organization's ability to withstand them. Stress testing should not only consider the probability of adverse events, but also potential "worst case" scenarios. Such an analysis should be done on a consolidated basis and consider, for example, the effect of higher than expected levels of delinquencies and defaults. The analysis should also consider the consequences of early amortization events that could raise concerns regarding a banking organization's capital adequacy and its liquidity and funding capabilities. Stress test analyses should also include contingency plans regarding the actions management might take given certain situations.

[9] Assets transferred with any amount of recourse in a transaction reported as a financing in accordance with generally accepted accounting principles (GAAP) remain on the balance sheet and are risk-weighted in the same manner as any other on-balance sheet asset. Assets transferred with recourse in a transaction that is reported as a sale under GAAP are removed from the balance sheet and are treated as off-balance sheet exposures for risk-based capital purposes.

[10] Consistent with statutory requirements, the agencies' current rules also provide for special treatment of sales of small business loan obligations with recourse. *See* 12 CFR Part 3, appendix A, Section 3(c) (OCC); 12 CFR parts 208 and 225, appendix A, II.B.5 (FRB); 12 CFR part 325, appendix A, II.B.6 (FDIC); 12 CFR 567.6(E)(3) (OTS).

[11] Section 350 of the CDRI Act required the agencies to prescribe regulations providing that the risk-based capital requirement for assets transferred with recourse could not exceed a banking organization's maximum contractual exposure. The agencies may require a higher amount if necessary for safety and soundness reasons. *See* 12 U.S.C. 4808.

banking organization's balance sheet and the banking organization need not hold leverage capital against these assets. However, if the seller's balance sheet includes as an asset any retained interest in the assets sold, leverage capital must be held against the retained interest.

2. Direct Credit Substitutes

Direct credit substitutes are treated differently from recourse under the current risk-based capital standards. Under the banking agencies' current standards, 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 amount, so that capital is held only against the face amount of the direct credit substitute. The capital requirement for a recourse arrangement, in contrast, generally is based on the full amount of the assets enhanced.

If a direct credit substitute covers less than 100% of the potential 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 the first 20% of the assets enhanced, then the on-balance sheet credit equivalent amount equals that 20% amount, and risk-based capital is held against only the 20% amount. In contrast, required capital for a first-loss 20% recourse arrangement is higher because capital is held against the full outstanding amount of the assets enhanced, subject to the low-level recourse rule.

Currently, under the banking agencies' guidelines, purchased subordinated interests receive the same capital treatment as off-balance sheet direct credit substitutes. That is, the amount of the purchased subordinated interest is placed in the appropriate risk-weight category. In contrast, a banking organization that *retains* a subordinated interest in connection with the transfer of its own assets is considered to have transferred the assets with recourse. As a result, the banking organization must hold capital against the carrying amount of the retained subordinated interest as well as the outstanding amount of all senior interests that it supports, subject to the low-level recourse rule.

The OTS risk-based capital regulation treats some forms of direct credit substitutes (*e.g.,* financial standby letters of credit) in the same manner as the banking agencies' guidelines. However, unlike the banking agencies, the OTS treats purchased subordinated interests (except for certain high quality subordinated mortgage-related securities) under its general recourse provisions. 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. Concerns Raised by Current Risk-Based Capital Treatment

The agencies' current risk-based capital standards raise significant concerns with respect to the treatment of recourse and direct credit substitutes. First, banking organizations are often required to hold different amounts of capital for recourse arrangements and direct credit substitutes that expose the banking organization to equivalent risk of credit loss. Banking organizations are taking advantage of this anomaly, for example, by providing first-loss letters of credit to asset-backed commercial paper conduits that lend directly to corporate customers. This results in a significantly lower capital requirement than if the loans had originally been carried on the banking organizations' balance sheets and then were sold. Moreover, the current capital standards do not recognize differences in risk associated with different loss positions in asset securitizations, nor do they provide uniform definitions of recourse, direct credit substitute, and associated terms.

III. Description of the Proposal

This proposal would amend the agencies' risk-based capital standards as follows:

- The proposal defines "recourse" and revises the definition of "direct credit substitute"; [12]
- It provides more consistent risk-based capital treatment for recourse obligations and direct credit substitutes;
- It varies the capital requirements for positions in securitized transactions according to their relative risk exposure, using credit ratings from nationally recognized statistical rating organizations [13] (rating agencies) to measure the level of risk;
- It permits the limited use of a banking organization's qualifying internal risk rating system, a rating agency's or other appropriate third party's review of the credit risk of positions in structured programs, and qualifying software to determine the capital requirement for certain unrated direct credit substitutes; and
- It requires the sponsor of a revolving credit securitization that involves an early amortization feature to hold capital against the amount of assets under management in that securitization.

The use of credit ratings in this proposal is similar to the 1997 Proposal. Although many commenters expressed concerns about specific details in the 1997 Proposal, commenters generally supported the goal of making the capital requirements associated with asset securitizations more rational and efficient, and viewed the 1997 Proposal as a positive step toward achieving a more consistent, rational, and efficient regulatory capital framework. The agencies have made several changes to the 1997 Proposal in response to commenters' concerns and based on further agency consideration of the issues presented.

Several options and alternatives in the 1997 Proposal have been eliminated: the modified gross-up approach, the ratings benchmark approach, and the historical losses approach.[14] Commenters expressed numerous concerns about these approaches and the agencies agree that better alternatives exist.

Commenters responding to the 1997 Proposal expressed a number of concerns about the use of ratings from rating agencies to determine capital requirements, especially in the case of unrated direct credit substitutes. Commenters noted that banking organizations actively involved in the securitization business have their own internal risk rating systems, that banking organizations know their assets better than third parties, and that a requirement that a banking organization obtain a rating from a rating agency solely for regulatory capital purposes is burdensome. Some commenters also expressed skepticism about the suitability of rating agency credit ratings for regulatory capital purposes.

In the opinion of the agencies, ratings have the advantages of being relatively objective, widely used, and relied upon by investors and other participants in

[12] The OTS, which already defines the term "recourse" in its rules, would revise its definition so that it is consistent with the definition adopted by the other agencies. The OTS is also adding a definition of "financial guarantee-type letter of credit" to be consistent with the OCC and the Board.

[13] "Nationally recognized statistical rating organization" means an entity recognized by the Division of Market Regulation of the Securities and Exchange Commission as a nationally recognized statistical rating organization for various purposes, including the capital rules for broker-dealers. *See* SEC Rule 15c3–1(c)(2)(vi)(E), (F) and (H), 17 CFR 240.15c3–091(c)(2)(vi)(E), (F), and (H).

[14] For a description of these approaches, *see* 62 FR 59944, 59952–59961 (November 5, 1997).

the financial markets. Ratings provide a flexible, efficient, market-oriented way to measure credit risk. The agencies recognize, however, that there are drawbacks to using credit ratings from rating agencies to set capital requirements. Moreover, the agencies agree with some commenters' observation that credit ratings are most useful with respect to publicly-traded positions that would be rated regardless of the agencies' risk-based capital requirements.

To minimize the need for banking organizations to obtain ratings on otherwise unrated enhancements that are provided in asset-backed commercial paper securitizations, the proposal permits banking organizations to use their own qualifying internal risk rating systems in place of ratings from rating agencies for risk weighting certain direct credit substitutes. The use of internal risk ratings to assign direct credit substitutes in asset-backed commercial paper programs to rating categories under the ratings-based approach is dependent upon the existence of adequate internal risk rating systems. The adequacy of any internal risk rating system will depend upon a banking organization's incorporation of the prudential standards outlined in this proposal, as well as other factors recommended through supervisory guidance or on a case-by-case basis.

Finally, the agencies are proposing an additional measure to address the risk associated with early amortization features in certain asset securitizations. The managed assets approach, described in Section III.D., would apply a 20% risk weight to the amount of off-balance sheet securitized assets under management in such transactions.

A. Definitions and Scope of the Proposal

1. Recourse

The proposal defines the term ''recourse'' to mean an arrangement in which a banking organization *retains* risk of credit loss in connection with an asset transfer, if the risk of credit loss exceeds a *pro rata* share of the banking organization's claim on the assets. The proposed definition of recourse is consistent with the banking agencies' longstanding use of this term, and incorporates existing agency practices regarding retention of risk in asset transfers into the risk-based capital standards.[15]

Currently, the term ''recourse'' is not defined explicitly 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 for Risk-Based Capital Purposes''). Once a definition of recourse is adopted in the risk-based capital guidelines, the banking agencies would remove the cross-reference to the Call Report instructions from the guidelines. The OTS capital regulation currently provides a definition of the term ''recourse,'' which would also be replaced once a final definition of recourse is adopted.

2. Direct Credit Substitute

The proposed definition of ''direct credit substitute'' complements the definition of recourse. The term ''direct credit substitute'' would refer to any arrangement in which a banking organization assumes risk of credit-related losses from assets or other claims it has not transferred, if the risk of credit loss exceeds the banking organization's *pro rata* share of the assets or other claims. Currently, under the banking agencies' guidelines, this term covers guarantee-type arrangements. As revised, it would also include explicitly items such as purchased subordinated interests, agreements to cover credit losses that arise from purchased loan servicing rights, credit derivatives and lines of credit that provide credit enhancement.

Some commenters responding to the 1997 Proposal suggested that the definition of ''direct credit substitute'' should exclude risk positions that are not part of an asset securitization. Although direct credit substitutes commonly are used in asset securitizations, enhancements involving similar credit risk exposure can arise in other contexts and should receive the same capital treatment as enhancements associated with securitizations.

Several commenters objected to the 1997 Proposal's treatment of direct credit substitutes as recourse. Commenters asserted that the business of providing third-party credit enhancements has historically been safe and profitable for banks and objected that the proposed capital treatment would impair the competitive position of U.S. banks and thrifts. As has been previously described, however, the current treatment of direct credit substitutes is not consistent with the treatment of recourse obligations. The agencies have concluded that the difference in treatment between the two forms of credit enhancement invites banking organizations to obtain direct credit substitutes in place of recourse obligations in order to avoid the capital requirement applicable to recourse obligations and on-balance-sheet assets. For this reason, the agencies are again proposing, as a general rule, to extend the current risk-based capital treatment of asset transfers with recourse, including the low-level recourse rule, to direct credit substitutes.

In an effort to address competitive inequities at the international level, however, the agencies have raised this issue with the bank supervisory authorities from the other countries represented on the Basel Committee on Banking Supervision. The Basel Committee's consultative paper, ''A New Capital Adequacy Framework,'' acknowledges that the current Basel Capital Accord, upon which the agencies' risk-based capital standards are based, lacks consistency in its treatment of credit enhancements.

3. Lines of Credit

One commenter requested clarification that a line of credit that provides credit enhancement for the financial obligations of an account party could be a direct credit substitute only if it represented an irrevocable obligation to the beneficiary. A revocable line of credit would not be a direct credit substitute because the issuer could protect itself against credit losses at any time prior to a draw on the line of credit. However, an irrevocable line of credit could expose the issuer to credit losses and would constitute a direct credit substitute, if it met the criteria in the definitions. Also, any conditions attached to the issuer's ability to revoke the undrawn portion of a line of credit, or that interfere with the issuer's ability to protect itself against credit loss prior to a draw, will cause the line of credit to constitute a direct credit substitute.

4. Credit Derivatives

The proposed definitions of ''recourse'' and ''direct credit substitute'' cover credit derivatives to the extent that a banking organization's credit risk exposure exceeds its *pro rata* interest in the underlying obligation. The ratings-based approach therefore applies to rated instruments such as credit-linked notes issued as part of a

[15] The OTS currently defines the term ''recourse'' more broadly than the proposal to include arrangements involving 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, credit risk that a banking organization assumes from third-party assets falls under the definition of ''direct credit substitute'' rather than ''recourse.''

synthetic securitization.[16] The agencies request comment on the inclusion of credit derivatives in the definitions of ''recourse'' and ''direct credit substitute,'' as well as on the definition of ''credit derivative'' contained in the proposal.

5. Risks Other Than Credit Risks

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' traditional focus on credit risk. The agencies have undertaken other initiatives to ensure that the risk-based capital standards take interest rate risk and other non-credit related market risks into account.

6. Implicit Recourse

The definitions cover all arrangements that are recourse or direct credit substitutes in form or in substance. Recourse may also exist when a banking organization assumes risk of loss without an explicit contractual agreement or, if there is a contractual limit, when the banking organization assumes risk of loss in an amount exceeding the limit. The existence of implicit recourse is often a complex and fact-specific issue, usually demonstrated by a banking organization's actions to support a securitization beyond any contractual obligation. Actions that may constitute implicit recourse include: providing voluntary support for a securitization by selling assets to a trust at a discount from book value; exchanging performing for non-performing assets; or other actions that result in a significant transfer of value in response to deterioration in the credit quality of a securitized asset pool.

To date, the agencies have taken the position that when a banking organization provides implicit recourse, it generally should hold capital in the same amount as for assets sold with recourse. However, the complexity of many implicit recourse arrangements and the variety of circumstances under which implicit recourse may be provided raise issues about whether recourse treatment is always the most appropriate way to address the level of risk that a banking organization has effectively retained or whether a different capital requirement would be warranted in some circumstances. Accordingly, the 1997 Proposal requested comment on the types of actions that should be considered implicit recourse and how the agencies should treat those actions for regulatory capital purposes.

Commenters responding to the 1997 Proposal generally supported the view that implicit recourse is best handled on a case-by-case basis, guided by the general rule that actions that demonstrate retention of risk will trigger recourse treatment of affected transactions. The agencies intend to continue to address implicit recourse case-by-case, but may issue additional guidance if needed to clarify further the circumstances in which a banking organization will be considered to have provided implicit recourse.

7. Subordinated Interests in Loans or Pools of Loans

The definitions of recourse and direct credit substitute explicitly cover a banking organization'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. (The OTS currently treats both retained and *purchased* subordinated securities as recourse obligations.) Subordinated interests generally absorb more than their *pro rata* share of losses (principal and interest) from the underlying assets in the event of default. 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 credit protection for all of the more senior classes.[17]

Some commenters questioned the treatment of purchased subordinated interests as recourse. Subordinated interests expose holders to comparable risk regardless of whether the interests are retained or purchased. If purchased subordinated interests were not treated as recourse, banking organizations could avoid recourse treatment by swapping retained subordinated interests with other banking organizations or by purchasing subordinated interests in assets originated by a conduit. The proposal would mitigate the effect of treating purchased subordinated interests as recourse by reducing the capital requirement on interests that qualify under the multi-level approach described in section III.B.

8. Representations and Warranties

When a banking organization transfers assets, including servicing rights, it customarily makes representations and warranties concerning those assets. When a banking organization 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 proposal addresses those particular representations and warranties that function as credit enhancements, *i.e.* those where, typically, a banking organization agrees to protect purchasers or some other party from losses due to the default or non-performance of the obligor or insufficiency in the value of collateral. Therefore, to the extent a banking organization's representations and warranties function as credit enhancements to protect asset purchasers or investors from credit risk by obligating the banking organization to protect another party from losses due to credit risk in the transferred assets, the proposal treats them as recourse or direct credit substitutes.

The 1997 Proposal treated as recourse or a direct credit substitute any representation or warranty other than a standard representation or warranty. Standard representations and warranties were those referring to facts verified by the seller or servicer with reasonable due diligence or conditions within the control of the seller or servicer and those providing for the return of assets in the event of fraud or documentation deficiencies. Some commenters objected that the 1997 Proposal would treat as recourse many industry-standard warranties that impose only minor operational risk instead of true credit risk. Other commenters objected that the due diligence requirement was burdensome, and that it would impose compliance costs on banking organizations disproportionate to the risk assumed.

The current proposal focuses on whether a warranty allocates credit risk to the banking organization, rather than whether the warranty is somehow standard or customary within the industry. Several commenters suggested

[16] ''Synthetic securitization'' refers to the bundling of credit risk associated with on-balance sheet assets and off-balance sheet items for subsequent sale into the market. Credit derivatives, and in particular credit-linked notes, are used to structure a synthetic securitization. For more information on synthetic securitizations *see,* Joint OCC and Federal Reserve Board Issuance on Credit Derivatives, ''Capital Interpretations—Synthetic Collateralized Loan Obligations,'' dated November 15, 1999.

[17] Current OTS risk-based capital guidelines exclude certain high-quality subordinated mortgage-related securities from treatment as recourse arrangements due to their credit quality.

that the agencies expressly take accepted mortgage banking industry practice into account in determining whether a warranty should receive recourse treatment. However, the agencies are aware of warranties sometimes characterized as ''standard'' that effectively function as credit enhancements. These include warranties that transferred loans will remain of investment quality, or that no circumstances exist involving the loan collateral or borrower's credit standing that could cause the loan to become delinquent. They may also include warranties that, for seasoned mortgages, the value of the loan collateral still equals the original appraised value and the borrower's ability to pay has not changed adversely.

The proposal is consistent with the agencies' longstanding recourse treatment of representations and warranties that effectively guaranty performance or credit quality of transferred loans. However, the proposal and the agencies' longstanding practice also recognize that banking organizations typically make a number of factual warranties unrelated to ongoing performance or credit quality. These warranties entail operational risk, as opposed to the open-ended credit risk inherent in a financial guaranty. Warranties that create operational risk include: warranties that assets have been underwritten or collateral appraised in conformity with identified standards, and warranties that provide for the return of assets in instances of incomplete documentation or fraud.

Warranties can impose varying degrees of operational risk. For example, a warranty that asset collateral has not suffered damage from hazard entails risk that is offset to some extent by prudent underwriting practices requiring the borrower to provide hazard insurance to the banking organization. A warranty that asset collateral is free of environmental hazards may present acceptable operational risk for certain types of properties that have been subject to environmental assessment, depending on the circumstances. The agencies address appropriate limits for these operational risks through supervision of a banking organization's loan underwriting, sale, and servicing practices. Also, a banking organization that provides warranties to loan purchasers and investors must include associated operational risks in its risk management of exposures arising from loan sale or securitization-related activities. Banking organizations should be prepared to demonstrate to examiners that the operational risks are effectively managed.

The proposal continues the agencies' current practice of imposing recourse treatment on ''early-default'' clauses. Early-default clauses typically warrant that transferred loans will not become more than 30 days delinquent within a stated period, such as four months. Once the stated period has run, the early-default clause will no longer trigger recourse treatment, provided that there is no other provision that constitutes recourse. One commenter to the 1997 Proposal stated that early-default clauses carry minimal risk, and are intended to deal with inadvertent transfers of loans that are already 30-day delinquencies, or to guard against unsound originations by the loan seller. Another commenter found recourse treatment of early-default clauses to be an appropriate response to the transfer of credit risk that takes place under these clauses.

The agencies find that early-default clauses are often drafted so broadly that they are indistinguishable from a guaranty of financial assets. The agencies have even found recent examples in which early-default clauses have been expanded to cover the first year after loan transfer. Industry concerns about assets delinquent at the time of transfer or unsound originations could be dealt with by warranties directly addressing the condition of the asset at the time of transfer and compliance with stated underwriting standards or, failing that, exposure caps permitting the banking organization to take advantage of the low-level recourse rule. The proposal also requires recourse treatment for warranties providing assurances about the actual value of asset collateral, including that the market value corresponds to its appraised value or that the appraised value will be realized in the event of foreclosure and sale.

The agencies invite further comment on these issues. The agencies also invite comment on whether ''premium refund'' clauses should receive recourse treatment under any final rule. These clauses require the seller to refund the premium paid by the investor for any loan that prepays within a stated period after the loan is transferred. The agencies are aware of premium refund clauses with terms ranging from 90 days to 36 months.

9. Loan Servicing Arrangements

The proposed definitions of ''recourse'' and ''direct credit substitute'' cover loan servicing arrangements if the servicer is responsible for credit losses associated with the loans being serviced. However, cash advances made by residential mortgage servicers to ensure an uninterrupted flow of payments to investors or the timely collection of the mortgage loans are specifically excluded from the definitions of recourse and direct credit substitute, provided that the residential mortgage servicer is entitled to reimbursement for any significant advances.[18] This type of advance is assessed risk-based capital only against the amount of the cash advance, and is assigned to the risk-weight category appropriate to the party obligated to reimburse the servicer.

If a residential mortgage 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 servicer's obligation to make cash advances 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 mortgage servicing function and do not constitute credit enhancements.

Commenters responding to the 1997 Proposal generally supported the proposed definition of servicer cash advances. Some commenters asked for clarification of the term ''insignificant'' and whether ''reimbursement'' includes reimbursement payable out of subsequent collections or reimbursement in the form of a general claim on the party obligated to reimburse the servicer. Nonreimbursed advances on any one loan that are generally contractually limited to no more than one percent of the amount of the outstanding principal on that loan would be considered insignificant. Reimbursement includes reimbursement payable from subsequent collections and reimbursement in the form of a general claim on the party obligated to reimburse the servicer, provided that the claim is not subordinated to other claims on the cash flows from the underlying asset pool.

Some commenters responding to the 1997 Proposal suggested that the agencies treat servicer cash advances as any advances that the servicer reasonably expects will be repaid. The agencies believe that a clear, specific standard is needed to prevent the use of servicer cash advances to circumvent the proposed risk-based capital

[18] Servicer cash advances 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).

treatment of recourse obligations and direct credit substitutes.

10. Spread Accounts and Overcollateralization

Several commenters requested that the agencies state in their rules that spread accounts and overcollateralization do not impose a risk of loss on a banking organization and are, therefore, not recourse. By its terms, the definition of recourse covers only the retention of risk in a sale of assets. Overcollateralization does not ordinarily impose a risk of loss on a banking organization, so it normally would not fall within the proposed definition of recourse. However, a retained interest in a spread account that is reflected as an asset on a selling banking organization's balance sheet (directly as an asset or indirectly as a receivable) is a form of recourse and is treated accordingly for risk-based capital purposes.

11. Interaction With Market Risk Rule

Some commenters responding to the 1997 Proposal asked for clarification of the treatment of a transaction covered by both the market risk rule and the recourse rule. Under the market risk rule,[19] a position properly located in the trading account is excluded from risk-weighted assets. The banking agencies are not proposing to modify this treatment, so a position that is properly held in the trading account would not be included in risk-weighted assets, even if the position otherwise met the criteria for a recourse obligation or a direct credit substitute.

12. Participations in Direct Credit Substitutes

If a direct credit substitute is originated by a banking organization which then sells a participation in that direct credit substitute to another entity, the originating banking organization must apply a 100% conversion factor to the full amount of the assets supported by the direct credit substitute. The originating banking organization would then risk weight the credit equivalent amount of the participant's *pro rata* share of the direct credit substitute at the lower of the risk category appropriate to the obligor in the underlying transaction, after considering any relevant guaranties or collateral, or the risk category appropriate to the participant entity. The remaining *pro rata* share of the credit equivalent amount is assigned to the risk-weight category appropriate to the obligor in the underlying transaction, guarantor or collateral.

A banking organization that acquires a risk participation in a direct credit substitute must apply a 100% conversion factor to its percentage share of the direct credit substitute multiplied by the full amount of the assets supported by the credit enhancement. The credit equivalent amount is then assigned to the risk category appropriate to the obligor or, if relevant, the nature of the collateral or guaranty.

Finally, in the case of the syndication of a direct credit substitute where each banking organization is obligated only for its *pro rata* share of the risk and there is no recourse to the originating banking organization, each banking organization must hold risk-based capital against its *pro rata* share of the assets supported by the direct credit substitute.

13. Reservation of Authority

The agencies are proposing to add language to the risk-based capital standards that will provide greater flexibility in administering the standards. Banking organizations are developing novel transactions that do not fit well into the risk-weight categories and credit conversion factors set forth in the standards. Banking organizations also are devising novel instruments that nominally fit into a particular risk-weight category or credit conversion factor, but that impose risks on the banking organization at levels that are not commensurate with the nominal risk-weight or credit conversion factor for the asset, exposure or instrument. Accordingly, the agencies are proposing to add language to the standards to clarify their authority, on a case-by-case basis, to determine the appropriate risk-weight for assets and credit equivalent amounts and the appropriate credit conversion factor for off-balance sheet items in these circumstances. Exercise of this authority by the agencies may result in a higher or lower risk weight for an asset or credit equivalent amount or a higher or lower credit conversion factor for an off-balance sheet item. This reservation of authority explicitly recognizes the agencies retention of sufficient discretion to ensure that banking organizations, as they develop novel financial assets, will be treated appropriately under the risk-based capital standards.[20] In addition, the agencies reserve the right to assign risk positions in securitizations to appropriate risk categories if the credit rating of the risk position is deemed to be inappropriate.

14. Privately-Issued Mortgage-Backed Securities

Currently, the agencies assign privately-issued mortgage-backed securities to the 20% risk-weight category if the underlying pool is composed entirely of mortgage-related securities issued by the Federal National Mortgage Association (Fannie Mae), Federal Loan Mortgage Corporation (Freddie Mac), or Government National Mortgage Association (Ginnie Mae). Privately-issued mortgage-backed securities backed by whole residential mortgages are now assigned to the 50% risk-weight category. The agencies propose to eliminate this ''pass-through'' treatment in favor of a ratings based approach. Because most mortgage-backed securities usually also receive the highest or second highest credit rating, the agencies believe that ''pass-through'' treatment will be redundant once the ratings-based approach is implemented and, therefore, propose to eliminate it.

B. Proposed Treatment for Rated Positions

As described in section II.A., each loss position in an asset securitization structure 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 requirement for different credit enhancements or loss positions to reflect differences in the relative risk of credit loss represented by the positions.

To address this issue, the agencies are proposing a multi-level, ratings-based approach to assess capital requirements on recourse obligations, direct credit substitutes, and senior and subordinated securities in asset securitizations based on their relative exposure to credit risk. The approach uses credit ratings from the rating agencies and, to a limited extent, banking organization's internal risk ratings and other alternatives, to measure relative exposure to credit risk and to determine the associated risk-based capital requirement. The use of credit ratings provides a way for the agencies to use determinations of credit quality relied upon by investors and other market participants to differentiate the regulatory capital treatment for loss

[19] The OTS does not have a market risk rule.

[20] The Board is also proposing to add language to its risk-based capital standards that would permit the Board to adjust the treatment of a capital instrument that does not fit into the existing capital categories or that provides capital to a banking organization at levels that are not commensurate with the nominal capital treatment of the instrument. The other agencies already have this flexibility under their existing rules.

positions representing different gradations of risk. This use permits the agencies to give more equitable treatment to a wide variety of transactions and structures in administering the risk-based capital system.

The fact that investors rely on these ratings to make investment decisions exerts market discipline on the rating agencies and gives their ratings market credibility. The market's reliance on ratings, in turn, gives the agencies confidence that it is appropriate to consider ratings as a major factor in the risk weighting of assets for regulatory capital purposes. The agencies, however, would retain their authority to override the use of certain ratings or the ratings on certain instruments, either on a case-by-case basis or through broader supervisory policy, if necessary or appropriate to address the risk to banking organizations.

Under the ratings-based approach, the capital requirement for a recourse obligation, direct credit substitute, or traded asset-backed security would be determined as follows: [21]

Rating category	Examples	Risk weight
Highest or second highest investment grade	AAA or AA	20%.
Third highest investment grade	A	50%.
Lowest investment grade	BBB	100%.
One category below investment grade	BB	200%.
More than one category below investment grade, or unrated	B or unrated	''Gross-up'' treatment.

Many commenters expressed concerns about the so-called ''cliff effect'' that would arise because of the small number of rating categories—three—contained in the 1997 Proposal. To reduce the cliff effect, which causes relatively small differences in risk to result in disproportionately large differences in the capital requirement for a risk position, the agencies are proposing to add two additional rating categories, for a total of five.

Under the proposal, the ratings-based approach is available for traded asset-backed securities [22] and for traded and non-traded recourse obligations and direct credit substitutes. A position is considered ''traded'' if, at the time it is rated by an external rating agency, there is a reasonable expectation that in the near future: (1) The position may be sold to investors relying on the rating; or (2) a third party may enter into a transaction (*e.g.,* a loan or repurchase agreement) involving the position in which the third party relies on the rating of the position. If external rating agencies rate a traded position differently, the single highest rating applies.

An unrated position that is senior (in all respects, including access to collateral) to a rated position that is traded is treated as if it had the rating given the rated position, subject to the banking organization satisfying its supervisory agency that such treatment is appropriate.

Recourse obligations and direct credit substitutes not qualifying for a reduced capital charge and positions rated more than one category below investment grade receive ''gross-up'' treatment, that is, the banking organization holding the position would hold capital against the amount of the position plus all more senior positions, subject to the low-level recourse rule.[23] This grossed-up amount is placed into risk-weight categories according to the obligor and collateral.

The ratings-based approach is based on current ratings, so that a rating downgrade or withdrawal of a rating could change the treatment of a position under the proposal. However, a downgrade of a position by a single rating agency would not affect the capital treatment of a position if the position still qualified for the previous capital treatment under one or more ratings from a different rating agency.

C. Proposed Treatment for Non-Traded and Unrated Positions

1. Ratings on Non-Traded Positions

In the 1994 Notice, the agencies proposed to permit a banking organization to obtain a rating for a non-traded recourse obligation or direct credit substitute in order to permit that position to qualify for a favorable risk-weight. In response to the 1994 Notice, one rating agency expressed concern that use of ratings by the agencies for regulatory purposes could undermine the integrity of the rating process. Ordinarily, according to the commenter, there is a tension between the interests of the investors who rely on ratings and the interests of the issuers who pay rating agencies to generate ratings. Under the ratings-based approach in the 1994 Notice, however, the holder of a recourse obligation or direct credit substitute that was not traded or sold could, in some cases, seek a rating for the sole purposes of permitting the credit enhancement to qualify for a favorable risk weight. The rating agency expressed a strong concern that, without the counterbalancing interest of investors to rely on ratings, rating agencies may have an incentive to issue inflated ratings.

In response to this concern, the 1997 Proposal included criteria to reduce the possibility of inflated ratings and inappropriate risk weights if ratings are used for a position that is not traded. A non-traded position could qualify for the ratings-based approach only if: (1) It qualified under ratings obtained from two different rating agencies; (2) the ratings were publicly available; (3) the ratings were based on the same criteria used to rate securities sold to the public; and (4) at least one position in the securitization was traded. In comments responding to the 1997 Proposal, banking organizations expressed concern about the cost and delay associated with obtaining ratings, particularly for direct credit substitutes, that they would not need absent the agencies' adoption of a ratings-based approach for risk-based capital purposes.

In this proposal, the agencies continue to permit a non-traded

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[21] The example rating designations (''AAA,'' ''BBB,'' etc.) are illustrative and do not indicate any preference for, or endorsement of, any particular rating agency designation system.

[22] Similar to the current approach under which ''stripped'' mortgage-backed securities are not eligible for risk weighting at 50% on a ''pass-through'' basis, stripped mortgage-backed securities are ineligible for the 20% or 50% risk categories under the ratings based approach.

[23] ''Gross-up'' treatment means that a position is combined with all more senior positions in the transaction. The result is then risk-weighted based on the nature of the underlying assets. For example, if a banking organization retains a first-loss position in a pool of mortgage loans that qualify for a 50% risk weight, the banking organization would include the full amount of the assets in the pool, risk-weighted at 50% in its risk-weighted assets for purposes of determining its risk-based capital ratio. The low level recourse rule provides that the dollar amount of risk-based capital required for assets transferred with recourse should not exceed the maximum dollar amount for which a banking organization is contractually liable. *See,* 12 CFR part 3, appendix A, Section 3(d) (OCC); 12 CFR 208 and 225, appendix A, III.D.1(g) (FRB); 12 CFR part 325, appendix A, II.D.1 (FDIC); 12 CFR 567.6(a)(2)(i)(C) (OTS).

recourse obligation or direct credit substitute to qualify for the ratings-based approach if the banking organization obtains ratings for the position. The agencies have retained the first three of the 1997 Proposal's four criteria for non-traded positions, but have eliminated the fourth criterion, *i.e.,* the requirement that one position in the securitization be traded.

To address concerns expressed by commenters on the 1997 Proposal, however, the agencies have developed, and are also proposing, alternative approaches for determining the capital requirements for unrated direct credit substitutes, which are discussed in the following sections. Under each of these approaches, the banking organization must satisfy its supervisory agency that use of the approach is appropriate for the particular banking organization.

2. Use of Banking Organizations' Internal Risk Ratings

The proposal would permit a banking organization with a qualifying internal risk rating system to use that system to apply the ratings-based approach to the banking organization's unrated direct credit substitutes in asset-backed commercial paper programs. Internal risk ratings could be used to qualify a credit enhancement (other than a retained recourse position) for a risk weight of 100% or 200% under the ratings-based approach, but not for a risk weight of less than 100%. This relatively limited use of internal risk ratings for risk-based capital purposes is a step towards potential adoption of broader use of internal risk ratings as discussed in the Basel Committee's June 1999 Consultative Paper. Limiting the approach to these types of credit enhancements reflects the agencies' view, based on industry research and empirical evidence, that these positions are more likely than recourse positions to be of investment-grade credit quality, and that the banking organizations providing them are more likely to have internal risk rating systems for these credit enhancements that are sufficiently accurate to be relied on for risk-based capital calculations.

Most sophisticated banking organizations that participate extensively in the asset securitization business assign internal risk ratings to their credit exposures, regardless of the form of the exposure. Usually, internal risk ratings more finely differentiate the credit quality of a banking organization's exposures than the categories that the agencies use to evaluate credit risk during examinations of banking organizations (pass, substandard, doubtful, loss). Individual banking organizations' internal risk ratings may be associated with a certain probability of default, loss in the event of default, and loss volatility.

The credit enhancements that sponsors obtain for their commercial paper conduits are rarely rated. If an internal risk ratings approach were not available for these unrated credit enhancements, the provider of the enhancement would have to obtain two ratings solely to avoid the gross-up treatment that would otherwise apply to unrated positions in asset securitizations for risk-based capital purposes. However, before a provider of an enhancement decides whether to provide a credit enhancement for a particular transaction (and at what price), the provider will generally perform its own analysis of the transaction to evaluate the amount of risk associated with the enhancement.

Allowing banking organizations to use internal credit ratings harnesses information and analyses that they already generate rather than requiring them to obtain independent but redundant ratings from outside rating agencies. An internal risk ratings approach therefore has the potential to be less costly than a ratings-based approach that relies exclusively on ratings by the rating agencies for the risk-weighting of these positions.

Internal risk ratings that correspond to the rating categories of the rating agencies could be mapped to risk weights under the agencies' capital standards in a way that would make it possible to differentiate the riskiness of various unrated direct credit substitutes based on credit risk. However, the use of internal risk ratings raises concerns about the accuracy and consistency of the ratings, especially because the mapping of ratings to risk-weight categories will give banking organizations an incentive to rate their risk exposures in a way that minimizes the effective capital requirement. Banking organizations engaged in securitization activities that wish to use the internal risk ratings approach must ensure that their internal risk rating systems are adequate. Adequate internal risk rating systems usually:

(1) Are an integral part of an effective risk management system that explicitly incorporates the full range of risks arising from an organization's participation in securitization activities. The system must also fully take into account the effect of such activities on the organization's risk profile and capital adequacy as discussed in Section II.B.

(2) Link their ratings to measurable outcomes, such as the probability that a position will experience any losses, the expected losses on that position in the event of default, and the degree of variance in losses given default on that position.

(3) Separately consider the risk associated with the underlying loans and borrowers and the risk associated with the specific positions in a securitization transaction.

(4) Identify gradations of risk among "pass" assets, not just among assets that have deteriorated to the point that they fall into "watch" grades. Although it is not necessary for a banking organization to use the same categories as the rating agencies, its internal ratings must correspond to the ratings of the rating agencies so that agencies can determine which internal risk rating corresponds to each rating category of the rating agencies. A banking organization would have the responsibility to demonstrate to the satisfaction of its primary regulator how these ratings correspond with the rating agency standards used as the framework for this proposal. This is necessary so that the mapping of credit ratings to risk weight categories in the ratings-based approach can be applied to internal ratings.

(5) Classify assets into each risk grade, using clear, explicit criteria, even for subjective factors.

(6) Have independent credit risk management or loan review personnel assign or review credit risk ratings. These personnel should have adequate training and experience to ensure that they are fully qualified to perform this function.

(7) Periodically verify, through an internal audit procedure, that internal risk ratings are assigned in accordance with the banking organization's established criteria.

(8) Track the performance of its internal ratings over time to evaluate how well risk grades are being assigned, make adjustments to its rating system when the performance of its rated positions diverges from assigned ratings, and adjust individual ratings accordingly.

(9) Make credit risk rating assumptions that are consistent with, or more conservative than, the credit risk rating assumptions and methodologies of the rating agencies.

The agencies also are considering whether to develop review and approval procedures governing their respective determinations of whether a particular banking organization may use the internal risk rating process. The agencies request comment on the appropriate scope and nature of that process.

If a banking organization's rating system is found to no longer be adequate, the banking organization's primary regulator may preclude it from applying the internal risk ratings approach to new transactions for risk-based capital purposes until it has remedied the deficiencies. Additionally, depending on the severity of the problems identified, the primary regulator may also decline to rely on the internal risk ratings that the banking organization has applied to previous transactions that remain outstanding for purposes of determining the banking organization's regulatory capital requirements.

3. Ratings of Specific Positions in Structured Financing Programs

The agencies also propose to authorize a banking organization to use a rating obtained from a rating agency or other appropriate third party of unrated direct credit substitutes in securitizations that satisfy specifications set by the rating agency. The banking organization would need to demonstrate that the rating meets the same rating standards generally used by the rating agency for rating publicly-issued securities. In addition, the banking organization must also demonstrate to its primary regulator's satisfaction that the criteria underlying the rating agency's assignment of ratings for the program are satisfied for the particular direct credit substitute issued by the banking organization.

The proposal would also allow banking organizations to demonstrate to the agencies that it is reasonable and consistent with the standards of this proposal to rely on the rating of positions in a securitization structure under a program in which the banking organization participates if the sponsor of that program has obtained a rating. This aspect of the proposal is most likely to be useful to banking organizations with limited involvement in securitization activities. In addition, some banking organizations extensively involved in securitization activities already rely on ratings of the credit risk positions under their securitization programs as part of their risk management practices. Such banking organizations also could rely on such ratings under this proposal if the ratings are part of a sound overall risk management process and the ratings reflect the risk of non-traded positions to the banking organizations.

This approach could be used to qualify a direct credit substitute (but not a retained recourse position) for a risk weight of 100% or 200% of the face value of the position under the ratings-based approach, but not for a risk weight of less than 100%.

4. Use of Qualifying Rating Software Mapped to Public Rating Standards

The agencies are also proposing to allow banking organizations, particularly those with limited involvement in securitization activities, to rely on qualifying credit assessment computer programs that the rating agencies or other appropriate third parties have developed for rating otherwise unrated direct credit substitutes in asset securitizations. To qualify for use by banking organizations for risk-based capital purposes, the computer programs must be tracked to the rating standards of the rating agencies. Banking organizations must demonstrate the credibility of these programs in the financial markets, which would generally be shown by the significant use of the computer program by investors and market participants for risk assessment purposes. Banking organizations also would need to demonstrate the reliability of the programs in assessing credit risk. Banking organizations may use these programs for purposes of applying the ratings-based approach under this proposal only if the banking organization satisfies its primary regulator that the programs result in credit assessments that credibly and reliably correspond with the rating of publicly issued securities by the rating agencies. Sophisticated banking organizations with extensive securitization activities generally should use this approach only if it is an integral part of their risk management systems and their systems fully capture the risks from the banking organizations' securitization activities.

This approach could be used to qualify a direct credit substitute (but not a retained recourse position) for a risk weight of 100% or 200% of the face value of the position under the ratings-based approach, but not for a risk weight of less than 100%.

D. Managed Assets Approach

When assets are securitized, the extent to which the selling or sponsoring entity transfers the risks associated with the assets depends on the structure of the securitization and the revolving nature of the assets involved. To the extent the sponsoring institution is dependent on future securitizations as a funding source, as a practical matter, the amount of risk transferred often will be limited. Revolving credits include credit card and home equity line securitizations as well as commercial loans drawn down under long-term commitments that are securitized as collateralized loan obligations (CLOs).

The early amortization feature present in some revolving credit securitizations ensures that investors will be repaid before being subject to any risk of significant credit losses. For example, if a securitized asset pool begins to experience credit deterioration to the point where the early amortization feature is triggered, then the asset-backed securities held by investors begin to rapidly pay down. This occurs because, after an early amortization feature is triggered, new receivables that are generated from the accounts designated to the securitization trust are no longer sold to investors, but are instead retained on the sponsoring banking organization's balance sheet.

Early amortization features raise several distinct concerns about risks to the seller. First, the seller's interest in the securitized assets is effectively subordinated to the interests of the investors by the payment allocation formula applied during early amortization. Investors effectively get paid first, and the seller's residual interest will therefore absorb a disproportionate share of credit losses.

Second, early amortization can create liquidity problems for the seller. For example, a credit card issuer must fund a steady stream of new credit card receivables. When a securitization trust is no longer able to purchase new receivables due to early amortization, the seller must either find an alternative buyer for the receivables or else the receivables will accumulate on the seller's balance sheet, creating the need for another source of funding.

Third, the first two risks to the seller can create an incentive for the seller to provide implicit recourse—credit enhancement beyond any pre-existing contractual obligation—to prevent early amortization. Incentives to provide implicit recourse are to some extent present in other securitizations, because of concerns about damage to the seller's reputation and its ability to securitize assets going forward if one of its securitizations performs poorly. However, the early amortization feature creates additional and more direct financial incentives to prevent early amortization through implicit recourse.

Because of their concerns about these risks, the agencies are proposing to apply a managed assets approach to securitization transactions that incorporate early amortization provisions. The approach would require a sponsoring banking organization's securitized (off-balance sheet) receivables to be included in risk-weighted assets when determining its risk-based capital requirements. The securitized, off-balance sheet assets would be assigned to the 20 percent risk category, thereby effectively applying a 1.6% risk-based capital charge to those assets.

The 1.6% capital charge against securitized assets could be limited in certain cases. If the sponsoring banking organization in a revolving credit securitization provides credit protection to investors, either in the form of retained recourse or a direct credit substitute, the sum of the regulatory capital requirements for the credit protection and the 1.6% charge on the off-balance sheet securitized assets may not exceed 8% of securitized assets for that particular securitization transaction.

A managed assets approach would require a banking organization to hold additional capital against the potential credit and liquidity risks stemming from the early amortization provisions of revolving credit securitization structures. This proposed capital charge would ensure that a banking organization maintain at least a minimum level of capital against the risks that arise when early amortization provisions are present in securitizations of revolving credits.

The agencies request comment on the purpose of early amortization provisions, the proposed managed assets approach, and on any potential effects that the approach will have on current industry practices involving revolving credit securitizations. The agencies also recognize that there may be concerns that the managed assets approach may not produce safety and soundness benefits commensurate with the additional regulatory burden that would result from a 20% risk weight on managed assets, and they request comment on possible alternative measures that would address more effectively the risks arising from early amortization provisions in revolving securitizations. For example, one alternative to the managed assets approach described here would be to require greater public disclosure of securitization performance. This additional information could allow market participants and regulators to better assess the risks inherent in revolving securitizations with early amortization provisions and the capital level appropriate for those risks. The agencies also request comment on whether the benefits of greater public disclosure outweigh the costs associated with increased reporting.

IV. Effective Date of a Final Rule Resulting From This Proposal

The agencies intend that any final rules adopted as a result of this proposal that result in increased risk-based capital requirements for banking organizations will apply only to securitization activities (as defined in the proposal) entered into or acquired after the effective date of those final rules. Conversely, any final rules that result in reduced risk-based capital requirements for banking organizations may be applied to all transactions outstanding as of the effective date of those final rules and to all subsequent transactions. Because some ongoing securitization conduits may need additional time to adapt to any new capital treatments, the agencies intend to permit banking organizations to apply the existing capital rules to asset securitizations with no fixed term, *e.g.*, asset-backed commercial paper conduits, for up to two years after the effective date of any final rule.

V. Request for Comment

The agencies request comment on all aspects of this proposal, as well as on the specific issues described in the preamble.

VI. Regulatory Flexibility Act

OCC: Pursuant to section 605(b) of the Regulatory Flexibility Act, the OCC certifies that this proposal will not have a significant impact on a substantial number of small entities. 5 U.S.C. 601 *et seq.* The provisions of this proposal that increase capital requirements are likely to affect large national banks almost exclusively. Small national banks rarely sponsor or provide direct credit substitutes in asset securitizations. Accordingly, a regulatory flexibility analysis is not required.

Board: Pursuant to section 605(b) of the Regulatory Flexibility Act, the Board has determined that this proposal will not have a significant impact on a substantial number of small business entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). The Board's comparison of the applicability section of this proposal with Call Report Data on all existing banks shows that application of the proposal to small entities will be the rare exception. Accordingly, a regulatory flexibility analysis is not required. In addition, because the risk-based capital standards generally do not apply to bank holding companies with consolidated assets of less than $150 million, this proposal will not affect such companies.

FDIC: Pursuant to section 605(b) of the Regulatory Flexibility Act (Public Law 96–354, 5 U.S.C. 601 *et seq.*), the FDIC certifies that the proposed rule will not have a significant impact on a substantial number of small entities. Comparison of Call Report data on FDIC-supervised banks to the items covered by the proposal that result in increased capital requirements shows that application of the proposal to small entities will be the infrequent exception.

OTS: Pursuant to section 605(b) of the Regulatory Flexibility Act, the OTS certifies that this proposal will not have a significant impact on a substantial number of small entities. A comparison of TFR data on OTS-supervised thrifts shows that the proposed rule would have little impact on the overall level of capital required at small thrifts, since capital requirements (other than the risk-based capital standards) are typically more binding on smaller thrifts. Moreover, the provisions of this proposal that may increase capital requirements are unlikely to affect small savings associations. Small thrifts rarely provide direct credit substitutes in asset securitizations and do not serve as sponsors of revolving securitizations. Accordingly, a regulatory flexibility analysis is not required.

VII. Paperwork Reduction Act

The Agencies have determined that this proposal does not involve a collection of information pursuant to the provisions of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501, *et seq.*).

VIII. Executive Order 12866

OCC: The OCC has determined that this proposal is not a significant regulatory action for purposes of Executive Order 12866. The OCC expects that any increase in national banks' risk-based capital requirement, resulting from the proposed treatment of direct credit substitutes largely will be offset by the ability of those banks to reduce their capital requirement in accordance with the ratings-based approach. The managed assets position of the proposal may require a limited number of national banks to raise additional capital in order to remain in the category to which they are assigned currently under the OCC's prompt corrective action framework. The OCC believes that the costs associated with raising this new capital are below the thresholds prescribed in the Executive Order. Nonetheless, the impact of any final rule resulting from this proposal will depend on factors for which the agencies do not currently collect industry-wide information, such as the proportion of bank-provided direct credit substitutes that would be rated below investment grade. The OCC, therefore, welcomes any quantitative information national banks wish to provide about the impact they expect the various portions of this proposal to have if issued in final form.

OTS: The Director of the OTS has determined that this proposal does not constitute a ''significant regulatory action'' under Executive Order 12866. Since OTS already applies a ''gross up'' treatment for recourse obligations and for most direct credit substitutes, the proposal generally is likely to reduce the risk-based capital requirements for thrifts. The proposed rule would increase capital requirements only for certain direct credit substitutes issued in connection with asset securitizations or for thrifts that may serve as sponsors of revolving securitization programs. Currently, thrifts rarely participate in such activities. As a result, OTS has concluded that the proposal will have only minor effects on the thrift industry.

IX. OCC and OTS—Unfunded Mandates Reform Act of 1995

Section 202 of the Unfunded Mandates Reform Act of 1995, Public Law 104–4, (Unfunded Mandates Act), requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in the expenditure by state, local, and tribal governments, in the aggregate, or by the private sector, of $100 million or more in any one year. If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. The OCC and OTS have determined that this proposed rule will not result in expenditures by state, local, and tribal governments, or by the private sector, of more than $100 million or more in any one year. Therefore, the OCC and OTS have not prepared a budgetary impact statement or specifically addressed the regulatory alternatives considered. As discussed in the preamble, this proposal will reduce inconsistencies in the agencies' risk-based capital standards and, in certain circumstances, will allow banking organizations to maintain lower amounts of capital against certain rated recourse obligations and direct credit substitutes.

X. Plain Language Requirement

Section 722 of the Gramm-Leach-Bliley Act of 1999 requires the federal banking agencies to use ''plain language'' in all proposed and final rules published after January 1, 2000. We invite your comments on how to make this proposal easier to understand. For example:

(1) Have we organized the material to suit your needs?

(2) Are the requirements in the rule clearly stated?

(3) Does the rule contain technical language or jargon that isn't clear?

(4) Would a different format (grouping and order of sections, use of headings, paragraphing) make the rule easier to understand?

(5) Would more (but shorter) sections be better?

(6) What else could we do to make the rule easier to understand?

XI. FDIC Assessment of Impact of Federal Regulation on Families

The FDIC has determined that this proposed rule will not affect family well-being within the meaning of section 654 of the Treasury and General Government Appropriations Act of 1999 (Pub. Law 105–277).

List of Subjects

12 CFR Part 3

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

12 CFR Part 208

Accounting, Agriculture, Banks, Banking, Confidential business information, Crime, Currency, Federal Reserve System, Mortgages, Reporting and recordkeeping requirements, Securities.

12 CFR Part 225

Administrative practice and procedure, Banks, Banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities.

12 CFR Part 325

Administrative practice and procedure, Bank deposit insurance, Banks, Banking, Capital adequacy, Reporting and recordkeeping requirements, Savings associations, State non-member banks.

12 CFR Part 567

Capital, Reporting and recordkeeping requirements, Savings associations.

Department of the Treasury

Office of the Comptroller of the Currency

12 CFR Chapter I

Authority and Issuance

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

PART 3—MINIMUM CAPITAL RATIOS; ISSUANCE OF DIRECTIVES

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

Authority: 12 U.S.C. 93a, 161, 1818, 1828(n), 1828 note, 1831n note, 1835, 3907, and 3909.

§ 3.4 [Amended]

2. In § 3.4:

A. The undesignated paragraph is designated as paragraph (a);

B. The second sentence in the newly designated paragraph (a) is revised; and

C. New paragraph (b) is added to read as follows:

§ 3.4 Reservation of authority.

(a) * * * Similarly, the OCC may find that a particular intangible asset need not be deducted from Tier 1 or Tier 2 capital. * * *

(b) Notwithstanding the risk categories in section 3 of appendix A to this part, the OCC may find that the assigned risk weight for any asset or the credit equivalent amount or credit conversion factor for any off-balance sheet item does not appropriately reflect the risks imposed on a bank and may require another risk weight, credit equivalent amount, or credit conversion factor that the OCC deems appropriate. Similarly, if no risk weight, credit equivalent amount, or credit conversion factor is specifically assigned, the OCC may assign any risk weight, credit equivalent amount, or credit conversion factor that the OCC deems appropriate. In making its determination, the OCC considers risks associated with the asset or off-balance sheet item as well as other relevant factors.

Appendix A to Part 3—[Amended]

3. In section 3 of appendix A:

A. Footnote 11a in paragraph (a)(3)(v) is revised;

B. Paragraph (b) introductory text is amended by adding a new sentence at its end;

C. Paragraph (b)(1)(i) and footnote 13 are removed and reserved;

D. Paragraph (b)(1)(ii) is revised;

E. Paragraph (b)(1)(iii) and footnote 14 are removed and reserved;

F. Footnotes 16 and 17 in paragraphs (b)(2)(i) and (ii), respectively, are revised; and

G. Paragraph (d) is revised to read as follows:

Appendix A to Part 3—Risk-Based Capital Guidelines

* * * * *

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

* * * * *

(a) * * *

(3) * * *

(v) * * * [11a]

* * * * *

(b) * * * However, direct credit substitutes, recourse obligations, and securities issued in connection with asset securitizations are treated as described in section 3(d) of this appendix A.

(1) * * *

(ii) Risk participations purchased in bankers' acceptances.

* * * * *

(2) * * *

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

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

* * * * *

(d) *Recourse obligations, direct credit substitutes, and asset-backed securities*—(1) *Definitions.* For purposes of this section 3 of this appendix A:

(i) *Covered representations and warranties* means representations and warranties that are made or assumed in connection with a transfer of assets (including loan servicing assets) and that obligate a bank to absorb losses arising from credit risk in the assets transferred or the loans serviced. Covered representations and warranties include promises to protect a party from losses resulting from the default or nonperformance of another party or from an insufficiency in the value of the collateral.

(ii) *Credit derivative* means a contract that allows one party (the beneficiary) to transfer the credit risk of an asset or off-balance sheet credit exposure to another party (the guarantor). The value of a credit derivative is dependent, at least in part, on the credit performance of a ''reference asset.''

(iii) *Direct credit substitute* means an arrangement in which a bank assumes credit risk associated with an on-or off-balance sheet asset 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. If a bank has no claim on the third-party asset, then the bank's assumption of any risk of credit loss is a direct credit substitute. Direct credit substitutes include:

(A) Financial guarantee-type standby letters of credit that support financial claims on a third party that exceed a bank's *pro rata* share in the financial claim;

(B) Guarantees, surety arrangements, credit derivatives and similar instruments backing financial claims that exceed a bank's *pro rata* share in the financial claim;

(C) Purchased subordinated interests that absorb more than their *pro rata* share of losses from the underlying assets;

(D) Entering into a credit derivative contract under which the bank assumes more than its *pro rata* share of credit risk on a third-party asset;

(E) Loans or lines of credit that provide credit enhancement for the securitization activities of a third party; and

(F) Purchased loan servicing assets if the servicer is responsible for credit losses or if the servicer makes or assumes covered representations and warranties with respect to the loans serviced. Cash advances described in section 4(d)(1)(vii) of this appendix A are not direct credit substitutes.

(iv) *Externally rated* means that an instrument or obligation has received a credit rating from at least one nationally recognized statistical rating organization.

(v) *Face amount* means the notional principal, or face value, amount of an off-balance sheet item; the amortized cost of an asset not held for trading purposes; and the fair value of a trading asset.

(vi) *Financial guarantee-type standby letter of credit* means a letter of credit or similar arrangement that represents an irrevocable obligation to a third-party beneficiary:

(A) To repay money borrowed by, or advanced to, or for the account of, a second party (the account party); or

(B) To make payment on behalf of the account party, in the event that the account party fails to fulfill its obligation to the beneficiary.

(vii) *Mortgage servicer cash advance* means funds that a mortgage servicer advances to ensure an uninterrupted flow of payments, including advances made to cover foreclosure costs or other expenses to facilitate the timely collection of the loan. A mortgage servicer cash advance is not a recourse obligation or a direct credit substitute if:

(A) The servicer is entitled to full reimbursement and this right is not subordinated to other claims on the cash flows from the underlying asset pool; or

(B) For any one loan, the servicer's obligation to make nonreimbursable advances is contractually limited to an insignificant amount.

(viii) *Nationally recognized statistical rating organization (NRSRO)* means an entity recognized by the Division of Market Regulation of the Securities and Exchange Commission (or any successor Division) (Commission) as a nationally recognized statistical rating organization for various purposes, including the Commission's uniform net capital requirements for brokers and dealers.

(ix) *Recourse* means the retention, by a bank, of any risk of credit loss directly or indirectly associated with a transferred asset that exceeds a *pro rata* share of that bank's claim on the asset. If a bank has no claim on a transferred asset, then the retention of any risk of credit loss is recourse. A recourse obligation typically arises when a bank transfers assets and retains an explicit obligation to repurchase assets or to absorb losses due to a default on the payment of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may also exist implicitly if a bank provides credit enhancement beyond any contractual obligation to support assets it has sold. The following are examples of recourse arrangements:

(A) Making covered representations and warranties on transferred assets;

(B) Retaining loan servicing assets pursuant to an agreement under which the bank will be responsible for losses associated with the loans serviced. Mortgage servicer cash advances, as defined in section 4(d)(1)(vii) of this appendix A, are not recourse arrangements;

(C) Retaining a subordinated interest that absorbs more than its *pro rata* share of losses from the underlying assets;

(D) Selling assets under an agreement to repurchase, if the assets are not already included on the balance sheet; and

(E) Selling loan strips without contractual recourse where the maturity

[11a] The portion of multifamily residential property loans that is sold subject to a *pro rata* loss sharing arrangement may be treated by the selling bank as sold to the extent that the sales agreement provides for the purchaser of the loan to share in any loss incurred on the loan on a *pro rata* basis with the selling bank. The portion of multifamily residential property loans sold subject to any loss sharing arrangement other than *pro rata* sharing of the loss shall be accorded the same treatment as any other asset sold under an agreement to repurchase or sold with recourse under section 3(d)(2) of this appendix A.

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

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

of the transferred portion of the loan is shorter than the maturity of the whole loan.

(x) *Risk participation* means a participation in which the originating bank remains liable to the beneficiary for the full amount of an obligation (*e.g.* a direct credit substitute) notwithstanding that another party has acquired a participation in that obligation.

(xi) *Securitization* means the pooling and repackaging of assets or other credit exposures into securities that can be sold to investors, including transactions that create stratified credit risk positions.

(xii) *Traded position* means a recourse obligation, direct credit substitute or asset-backed security retained, assumed or issued in connection with a securitization that is externally rated, where there is an expectation that, in the near future, the rating will be relied upon by:

(A) Investors to purchase the position; or

(B) A third party to enter into a transaction involving the position, such as a purchase, loan or repurchase agreement.

(2) *Credit equivalent amounts and risk weights of recourse obligations and direct credit substitutes*—(i) *Credit-equivalent amount.* Except as provided in sections 3(d)(3) and (4) of this appendix A, the credit-equivalent amount for a recourse obligation or direct credit substitute is the full amount of the credit-enhanced assets for which the bank directly or indirectly retains or assumes credit risk multiplied by a 100% conversion factor.

(ii) *Risk-weight factor.* To determine the bank's risk-weighted assets for off-balance sheet recourse obligations and direct credit substitutes, the credit equivalent amount is assigned to the risk category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral. For a direct credit substitute that is an on-balance sheet asset (*e.g.,* a purchased subordinated security), a bank must calculate risk-weighted assets using the amount of the direct credit substitute and the full amount of the assets it supports, *i.e.,* all the more senior positions in the structure.

(3) *Credit equivalent amount and risk weight of participations in, and syndications of, direct credit substitutes.* The credit equivalent amount for a participation interest in, or syndication of, a direct credit substitute is calculated and risk weighted as follows:

(i) In the case of a direct credit substitute in which a bank has conveyed a risk participation, the full amount of the assets that are supported by the direct credit substitute is converted to a credit equivalent amount using a 100% conversion factor. The *pro rata* share of the credit equivalent amount that has been conveyed through a risk participation is then assigned to whichever risk-weight category is lower: The risk-weight category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral, or the risk-weight category appropriate to the institution acquiring the participation. The *pro rata* share of the credit equivalent amount that has not been participated out is assigned to the risk-weight category appropriate to the obligor, guarantor, or collateral.

(ii) In the case of a direct credit substitute in which the bank has acquired a risk participation, the acquiring bank's percentage share of the direct credit substitute is multiplied by the full amount of the assets that are supported by the direct credit substitute and converted using a 100% credit conversion factor. The resulting credit equivalent amount is then assigned to the risk-weight category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral.

(iii) In the case of a direct credit substitute that takes the form of a syndication where each bank is obligated only for its *pro rata* share of the risk and there is no recourse to the originating bank, each bank's credit equivalent amount will be calculated by multiplying only its *pro rata* share of the assets supported by the direct credit substitute by a 100% conversion factor. The resulting credit equivalent amount is then assigned to the risk-weight category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral.

(4) *Externally rated positions: Credit-equivalent amounts and risk weights.*—(i) *Traded positions.* With respect to a recourse obligation, direct credit substitute, or asset-backed security that is a ''traded position'' and that has received an external rating that is one grade below investment grade or better, the bank shall multiply the face amount of the position by the appropriate risk weight, determined in accordance with Table B. [24]

[24] Stripped mortgage-backed securities, such as interest-only or principal-only strips, may be assigned only, at a minimum, to the 100% risk category.

TABLE B

Rating category	Examples	Risk weight (percent)
Highest or second highest investment grade.	AAA, AA ..	20
Third highest investment grade.	A	50
Lowest investment grade.	BBB	100
One category below investment grade.	BB	200

(ii) *Non-traded positions.* A recourse obligation or direct credit substitute extended in connection with a securitization that is not a ''traded position'' is assigned a risk weight in accordance with section 3(d)(4)(i) of this appendix A if:

(A) It has been externally rated one category below investment grade or better by two NRSROs;

(B) The ratings are publicly available; and

(C) The ratings are based on the same criteria used to rate securities sold to the public. If the two ratings are different, the lower rating will determine the risk category to which the recourse obligation or direct credit substitute will be assigned.

(5) *Senior positions not externally rated.* For a recourse obligation, direct credit substitute, or asset-backed security that is not externally rated but is senior in all credit-risk related features to a traded position (including collateralization), a bank may apply a risk weight to the face amount of the senior position in accordance with section 3(d)(4)(i) of this appendix A, based upon the traded position, subject to the bank satisfying the OCC that this treatment is appropriate.

(6) *Direct credit substitutes that are not externally rated.* A direct credit substitute extended in connection with a securitization that is not externally rated may risk weight the face amount of the direct credit substitute based on the bank's determination of the credit rating of the position, as specified in Table C. In order to qualify for this treatment, the bank's system for determining the credit rating of the direct credit substitute must meet one of the three alternative standards set out in section 3(d)(6)(i) through (iii) of this appendix A.

TABLE C

Rating category	Examples	Risk weight (percent)
Highest or second highest investment grade.	AAA, AA ..	100
Third highest investment grade.	A	100
Lowest investment grade.	BBB	100
One category below investment grade.	BB	200

(i) *Internal risk rating used for asset-backed programs.* The direct credit substitute is issued in connection with an asset-backed commercial paper program sponsored by the bank and the bank's internal credit risk rating system is adequate. Adequate internal credit risk rating systems usually contain the following criteria: [25]

(A) The internal credit risk system is an integral part of the bank's risk management system that explicitly incorporates the full range of risks arising from a bank's participation in securitization activities;

(B) Internal credit ratings are linked to measurable outcomes, such as the probability that the position will experience any loss, the position's expected loss given default, and the degree of variance in losses given default on that position;

(C) The bank's internal credit risk system must separately consider the risk associated with the underlying loans or borrowers, and the risk associated with the structure of a particular securitization transaction;

(D) The bank's internal credit risk system must identify gradations of risk among ''pass'' assets and other risk positions;

(E) The bank must have clear, explicit criteria that are used to classify assets into each internal risk grade, including subjective factors;

(F) The bank must have independent credit risk management or loan review personnel assigning or reviewing the credit risk ratings;

(G) An internal audit procedure should periodically verify that internal risk ratings are assigned in accordance with the banking organization's established criteria.

(H) The bank must monitor the performance of the internal credit risk ratings assigned to nonrated, nontraded direct credit substitutes over time to determine the appropriateness of the initial credit risk rating assignment and adjust individual credit risk ratings, or the overall internal credit risk ratings system, as needed; and

(I) The internal credit risk system must make credit risk rating assumptions that are consistent with, or more conservative than, the credit risk rating assumptions and methodologies of NRSROs.

(ii) *Program ratings.* The direct credit substitute is issued in connection with a securitization program and a NRSRO (or other entity satisfactory to the OCC) has reviewed the terms of the securitization and stated a rating for positions associated with the program. If the program has options for different combinations of assets, standards, internal credit enhancements and other relevant factors, and the NRSRO or other entity specifies ranges of rating categories to them, the bank may apply the rating category applicable to the option that corresponds to the bank's position. The bank must demonstrate to the OCC's satisfaction that the credit risk rating assigned to the program meets the same standards generally used by NRSROs for rating traded positions. In addition, the bank must also demonstrate to the OCC's satisfaction that the criteria underlying the NRSRO's assignment of ratings for the program are satisfied for the particular direct credit substitute issued by the bank. If a bank participates in a securitization sponsored by another party, the OCC may authorize the bank to use this approach based on a program rating obtained by the sponsor of the program.

(iii) *Computer program.* The bank is using an acceptable credit assessment computer program to determine the rating of a direct credit substitute extended in connection with a securitization. A NRSRO (or another entity approved by the OCC) must have developed the computer program and the bank must demonstrate to the OCC's satisfaction that ratings under the program correspond credibly and reliably with the rating of traded positions.

(7) *Off-balance sheet securitized assets subject to early amortization.* An asset that is sold by a bank into a revolving securitization sponsored by the bank, notwithstanding such sale, shall be converted to an on-balance sheet credit equivalent using a 100% conversion factor, and assigned to the 20 percent risk-weight category, if the securitization has an early amortization feature.[26] The total capital requirement for these assets, including capital charges arising from any retained recourse or direct credit substitute, may not exceed 8% of the amount of the assets in the securitization.

(8) *Limitations on risk-based capital requirements*—(i) *Low-level exposure rule.* If the maximum contractual liability or exposure to loss retained or assumed by a bank is less than the effective risk-based capital requirement for the asset supported by the bank's position, the risk based capital required under this appendix A is limited to the bank's contractual liability, less any recourse liability account established in accordance with generally accepted accounting principles.

(ii) *Related on-balance sheet assets.* If an asset is included in the calculation of the risk-based capital requirement under this section 3(d) of this appendix A and also appears as an asset on a bank's balance sheet, the asset is risk-weighted only under this section 3(d) of this appendix A, except in the case of loan servicing assets and similar arrangements with embedded recourse obligations or direct credit substitutes. In that case, both the on-balance sheet servicing assets and the related recourse obligations or direct credit substitutes are incorporated into the risk-based capital calculation.

* * * * *

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

* * * * *

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

100 Percent Conversion Factor

1. [Reserved]

* * * * *

Dated: February 9, 2000.

John D. Hawke, Jr.,

Comptroller of the Currency.

Federal Reserve System

12 CFR Chapter II

Authority and Issuance

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

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

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

Authority: 12 U.S.C. 24, 36, 92(a), 93(a), 248(a), 248(c), 321–338a, 371d, 461, 481–486,

[25] The adequacy of a bank's use of its internal credit risk rating system must be demonstrated to the OCC considering the criteria listed in this section and the size and complexity of the credit exposures assumed by the bank.

[26] This requirement does not apply to interests that the seller has retained.

601, 611, 1814, 1816, 1818, 1820(d)(9), 1823(j), 1828(o), 1831, 1831o, 1831p–1, 1831r–1, 1835(a), 1882, 2901–2907, 3105, 3310, 3331–3351, and 3906–3909; 15 U.S.C. 78b, 78l(b), 78l(g), 78l(i), 78o–4(c)(5), 78q, 78q–1, and 78w; 31 U.S.C. 5318; 42 U.S.C. 4012a, 4104a, 4104b, 4106, and 4128.

2. In appendix A to part 208:

A. The three introductory paragraphs to section *II.* are revised;

B. A new undesignated fifth paragraph is added at the end of section *III.*A;

C. In section *III.*B., paragraph 3 is revised and footnote 23 is removed, and in paragraph 4, footnote 24 is removed;

D. In section *III.*C., paragraphs 1 through 3, footnotes 25 through 37 are redesignated as footnotes 23 through 35, and paragraph 4 is revised;

E. In section *III.*D., the introductory paragraph and paragraph 1 are revised;

F. In sections *III.*D. and *III.*E., footnote 46 is removed and footnotes 47 through 51 are redesignated as footnotes 44 through 48; and

G. In section *IV.*B., footnote 52 is removed.

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

* * * * *

II. * * *

A bank's qualifying total capital consists of two types of capital components: ''core capital elements'' (comprising Tier 1 capital) and ''supplementary capital elements'' (comprising Tier 2 capital). These capital elements and the various limits, restrictions, and deductions to which they are subject, are discussed below and are set forth in Attachment II.

The Federal Reserve will, on a case-by-case basis, determine whether and, if so, how much of any liability that does not fit wholly within the terms of one of the capital categories set forth below or that does not have an ability to absorb losses commensurate with the capital treatment otherwise specified below will be counted as an element of Tier 1 or Tier 2 capital. In making such a determination, the Federal Reserve will consider the similarity of the liability to liabilities explicitly treated in the guidelines, the ability of the liability to absorb losses while the bank operates as a going concern, the maturity and redemption features of the liability, and other relevant terms and factors. To qualify as an element of Tier 1 or Tier 2 capital, a capital instrument may not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices.

Redemptions of permanent equity or other capital instruments before stated maturity could have a significant impact on a bank's overall capital structure. Consequently, a bank considering such a step should consult with the Federal Reserve before redeeming any equity or debt capital instrument (prior to maturity) if such redemption could have a material effect on the level or composition of the institution's capital base.[4]

* * * * *

III. * * *

A. * * *

The Federal Reserve will, on a case-by-case basis, determine the appropriate risk weight for any asset or the credit equivalent amount of an off-balance sheet item that does not fit wholly within the terms of one of the risk weight categories set forth below or that imposes risks on a bank that are incommensurate with the risk weight otherwise specified below for the asset or off-balance sheet item. In addition, the Federal Reserve will, on a case-by-case basis, determine the appropriate credit conversion factor for any off-balance sheet item that does not fit wholly within the terms of one of the credit conversion factors set forth below or that imposes risks on a bank that are incommensurate with the credit conversion factors otherwise specified below for the off-balance sheet item. In making such a determination, the Federal Reserve will consider the similarity of the asset or off-balance sheet item to assets or off-balance sheet items explicitly treated in the guidelines, as well as other relevant factors.

* * * * *

B. * * *

3. *Recourse obligations, direct credit substitutes, and asset- and mortgage-backed securities.* Direct credit substitutes, assets transferred with recourse, and securities issued in connection with asset securitizations and structured financings are treated as described below. Use of the term ''asset securitizations'' or ''securitizations'' in this rule includes structured financings, as well as asset securitization transactions.

a. *Definitions*—(i) *Credit derivatives* are on- or off-balance sheet notes or contracts that allow one party (the ''beneficiary'') to transfer the credit risk of a ''reference asset,'' which it often owns, to another party (the ''guarantor''). The value of a credit derivative is dependent, at least in part, on the credit performance of the reference asset, which typically is a publicly traded loan or corporate bond.

(ii) *Credit-enhancing representations and warranties* means representations and warranties extended by a bank when it transfers assets (including loan servicing assets) or assumed by the bank when it purchases loan servicing assets that obligate the bank to absorb credit losses on transferred assets or serviced loans. These representations and warranties typically arise when the bank agrees to protect purchasers or some other party from losses due to the default or nonperformance of the obligor on the transferred assets or serviced loans, or insufficiency in the value of collateral supporting the transferred assets or serviced loans.

(iii) *Direct credit substitute* means an arrangement in which a bank *assumes,* in form or in substance, any risk of credit loss directly or indirectly associated with a *third-party* asset or other financial claim, that exceeds the bank's *pro rata* share of the asset or claim. If the bank has no claim on the asset, then the assumption of *any* risk of loss is a direct credit substitute. Direct credit substitutes include, but are not limited to:

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

(*2*) Guarantees, surety arrangements, credit derivatives, and irrevocable guarantee-type instruments backing financial claims such as outstanding securities, loans, or other financial liabilities, or that back off-balance sheet items against which risk-based capital must be maintained;

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

(*4*) Loans or lines of credit that provide credit enhancement for the financial obligations of an account party; and

(*5*) Purchased loan servicing assets if the servicer is responsible for credit losses associated with the loans being serviced (other than mortgage servicer cash advances as defined in paragraph *III.*B.3.a.(vi) of this section), or if the servicer makes or assumes credit-enhancing representations and warranties with respect to the serviced loans.

(iv) *Externally rated* means, with respect to an instrument or obligation, that the instrument or obligation has received a credit rating from a nationally-recognized statistical rating organization.

(v) *Financial guarantee-type standby letter of credit* means any letter of credit or similar arrangement, however named or described, that represents an irrevocable obligation to the beneficiary on the part of the issuer:

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

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

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

(vii) *Nationally recognized statistical rating organization* means an entity recognized by the Division of Market Regulation of the Securities and Exchange Commission as a nationally recognized statistical rating organization for various purposes, including the Commission's uniform net capital requirements for brokers and dealers (17 CFR 240.15c3–1(c)(2)(vi)(E), (F), and (H)).

(viii) *Recourse* means an arrangement in which a bank *retains,* in form or in

[4] Consultation would not ordinarily be necessary if an instrument were redeemed with the proceeds of, or replaced by, a like amount of a similar or higher quality capital instrument and the organization's capital position is considered fully adequate by the Federal Reserve.

substance, any risk of credit loss directly or indirectly associated with a transferred asset that exceeds a *pro rata* share of the bank's claim on the asset. If a bank has no claim on a transferred asset, then the retention of any risk of loss is recourse. A recourse obligation typically arises when an institution transfers assets and retains an obligation to repurchase the assets or absorb losses due to a default of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may exist implicitly where a bank provides credit enhancement beyond any contractual obligation to support assets it has sold. Recourse obligations include, but are not limited to:

(*1*) Credit-enhancing representations and warranties on the transferred assets that obligate the servicer to absorb credit losses, including early-default clauses;

(*2*) Retained loan servicing assets if the servicer is responsible for losses associated with the loans being serviced other than mortgage servicer cash advances as defined in paragraph *III*.B.3.a.(vi) of this section.

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

(*4*) Assets sold under an agreement to repurchase if the assets are not already included on the balance sheet; and

(*5*) Loan strips sold without direct recourse where the maturity of the transferred loan that is drawn is shorter than the maturity of the commitment.

(ix) *Securitization* means the pooling and repackaging of loans or other credit exposures into securities that can be sold to investors. For purposes of this appendix A, securitization also includes structured finance transactions or programs that generally create stratified credit risk positions whose performance is dependent upon an underlying pool of credit exposures, including loans and commitments.

(x) *Traded position* means a recourse obligation, direct credit substitute, or asset-or mortgage-backed security that is retained, assumed, or issued in connection with an asset securitization and that is rated with a reasonable expectation that, in the near future:

(*1*) The position would be sold to investors relying on the rating; or

(*2*) A third party would, in reliance on the rating, enter into a transaction such as a purchase, loan, or repurchase agreement involving the position.

b. *Amount of position to be included in risk-weighted assets.* Other types of recourse obligations or direct credit substitutes, other than those listed in section III.B.3.b.(i)(*1*) through (*7*) of this appendix A, should be treated in accordance with the principles contained in section *III*.B.3. of this appendix A. The treatment of direct credit substitutes that have been syndicated or in which risk participations have been conveyed or acquired is set forth in section *III*.D.1 of this appendix A.

(i) *General rule for determining the credit equivalent amount and risk weight of recourse obligations and direct credit substitutes.* Except as otherwise provided in section *III* of this appendix A, the risk weighted asset amount or the credit equivalent amount for a recourse obligation or direct credit substitute is the full amount of the credit enhanced assets from which risk of credit loss is directly or indirectly retained or assumed. This credit equivalent amount is assigned to the risk weight category appropriate to the obligor or, if relevant, the guarantor or nature of any collateral. Thus, a bank that extends a partial direct credit substitute, *e.g.,* a financial standby letter of credit, that absorbs the first 10 percent of loss on a transaction, must maintain capital against the full amount of the assets being supported. Furthermore, for direct credit substitutes that are on-balance sheet assets, *e.g.,* purchased subordinated securities, banks must maintain capital against the amount of the direct credit substitutes and the full amount of the assets being supported, *i.e.,* all more senior positions. This treatment is subject to the low-level capital rule discussed in section *III*.B.3.c.i. of this appendix A. For purposes of this appendix A, the full amount of the credit enhanced assets from which risk of credit loss is directly or indirectly retained or assumed means for:

(*1*) A financial guarantee-type standby letter of credit, surety arrangement, credit derivative, guarantee, or irrevocable guarantee-type instruments, the full amount of the assets that the direct credit substitute fully or partially supports;

(*2*) A subordinated interest or security, the amount of the subordinated interest or security plus all more senior interests or securities;

(*3*) Mortgage servicing assets that are recourse obligations or direct credit substitutes, the outstanding amount of the loans serviced;

(*4*) Credit-enhancing representations and warranties, the amount of the assets subject to the representations or warranties;

(*5*) Loans or lines of credit that provide credit enhancement for the financial obligations of an account party, the full amount of the enhanced financial obligations;

(*6*) Loans strips, the amount of the loans; and

(*7*) For assets sold with recourse, the amount of assets for which risk of loss is directly or indirectly retained, less any applicable recourse liability account established in accordance with generally accepted accounting principles.

(ii) *Determining the credit risk weight of recourse obligations, direct credit substitutes, and asset- and mortgage-backed securities that are rated within one of the five highest rating categories.* (*1*) A traded position is eligible for the risk-based capital treatment described in this paragraph if its external rating is within one of the five highest rating categories, *e.g.,* AAA through BB, used by a nationally-recognized statistical rating organization. A recourse obligation, direct credit substitute, or asset- or mortgage-backed security which is not externally rated but is senior in all respects to a traded position that is externally rated, including access to any collateral, is also eligible for the risk-based capital treatment described in this paragraph *III*.B.3.b.(ii) as if it had the same rating as the traded position. This treatment for the unrated senior position is subject to current and prospective supervisory guidance on a case-by-case basis.

(*A*) *Two highest investment grades.* Except as otherwise provided in section *III.* of this appendix A, the face amount of a recourse obligation, direct credit substitute, or an asset- or mortgage-backed security that is rated in either of the two highest investment grade categories, *e.g.,* AAA or AA, is assigned to the 20 percent risk category.

(*B*) *Third highest investment grade.* Except as otherwise provided in this section *III.* of this appendix A, the face amount of a recourse obligation, direct credit substitute, or an asset-or mortgage-backed security that is rated in the third highest investment grade category, *e.g.,* A, is assigned to the 50 percent risk category.

(*C*) *Lowest investment grade.* Except as otherwise provided in this section *III.* of this appendix A, the face amount of a recourse obligation, direct credit substitute, or an asset-or mortgage-backed security that is rated in the lowest investment grade category, *e.g.,* BBB, is assigned to the 100 percent risk category.

(*D*) *One category below investment grade.* Except as otherwise provided in this section *III.* of this appendix A, the face amount of a recourse obligation, direct credit substitute, or an asset-or mortgage-backed security that is rated in the next lower category below the lowest investment grade category, *e.g.,* BB, is assigned a 200 percent risk weight.

(*2*) Nontraded recourse obligations, direct credit substitutes, or asset-or mortgage-backed securities that are retained, assumed or issued in connection with an asset securitization also are eligible for the treatment described in this paragraph *III*.B.3.b.(ii) if they are externally rated within one of the five highest rating categories by two nationally-recognized statistical rating organizations, the ratings are publicly available, and the ratings are based on the same criteria used to rate securities sold to the public.

(*3*) A direct credit substitute extended in connection with an asset securitization that is not a traded position and is not externally rated by a nationally-recognized statistical rating organization (such as a letter of credit) may be eligible for the treatment described in section *III*.B.3.b.(ii)(1)(*C*) and (D) of this appendix A, *i.e., a minimum risk weight of 100 percent,* if it satisfies the criteria of one of the following approaches deemed appropriate for the institution by the Federal Reserve:

(*A*) A bank, under its qualifying internal risk rating system, assigns an internal rating to a direct credit substitute extended to an asset-backed commercial paper program that is equivalent to an external credit rating one category below investment grade or higher provided by a nationally recognized statistical rating organization. A qualifying internal risk rating system must be reviewed and deemed appropriate by the Federal Reserve and must satisfy the following criteria and any other prudential standards that the Federal Reserve determines are necessary. Qualifying internal risk rating systems at a minimum must:

(*i*) Be an integral part of an effective risk management system that explicitly incorporates the full range of risks arising from a bank's participation in securitization activities;

(*ii*) Link the internal ratings to measurable outcomes, such as the probability that the position will experience any loss, the position's expected loss given default, and the degree of variance in losses given default on that position;

(*iii*) Separately consider the risk associated with the underlying loans or borrowers, and the risk associated with the structure of a particular securitization transaction;

(*iv*) Identify gradations of risk among ''pass'' assets and other risk positions;

(*v*) Have clear, explicit criteria that are used to classify assets into each internal risk grade, including subjective factors;

(*vi*) Have independent credit risk management or loan review personnel assigning or reviewing the credit risk ratings;

(*vii*) Have an internal audit procedure that periodically verifies that the internal credit risk ratings are assigned in accordance with the established criteria;

(*viii*) Monitor the performance of the internal ratings assigned to nonrated nontraded direct credit substitutes over time to determine the appropriateness of the initial rating assignment and adjust individual ratings accordingly; and

(*ix*) Be consistent with, or more conservative than, the rating assumptions and methodologies of nationally recognized statistical rating organizations.

(*B*) A bank's direct credit substitute extended to a securitization or structured finance program is reviewed by a nationally recognized statistical rating organization, in conjunction with a review of the overall program, and is assigned a rating or its equivalent. If the program has options for different combinations of assets, standards, internal credit enhancements, and other relevant factors, the rating organization may specify ranges of rating categories that may apply premised on which options are utilized by the bank's risk position. The bank must demonstrate to the Federal Reserve that the nationally recognized statistical rating organization's programmatic rating for its risk position generally meets the same standards used by the rating organization for rating traded positions, and that the rating organization's underlying premises are satisfied for particular direct credit substitutes issued by the bank. If a bank participates in a securitization or structured finance program sponsored by another party, the Federal Reserve may authorize the bank to use this approach based on a programmatic rating obtained by the sponsor of the program.

(*C*) A bank may rate its credit risk exposure to direct credit substitutes by relying on a qualifying credit assessment computer program. A nationally recognized statistical rating agency or other acceptable third party must have developed such a credit assessment system for determining the credit risk of direct credit substitutes and other stratified credit positions. Banks must demonstrate to the Federal Reserve that ratings under such a credit assessment computer program correspond credibly and reliably with the ratings assigned by the rating agencies to publicly traded securities.

(iii) *Determining the credit risk weight for off-balance sheet securitized assets that are subject to early amortization provisions.* If a bank securitizes revolving assets, such as credit cards, home equity lines, or commercial loans issued under lines of credit, in a securitization transaction that it has sponsored and which includes early amortization provisions, then the sponsoring bank must maintain risk-based capital against the off-balance sheet securitized assets from the inception of the transaction. An early amortization feature is a provision that, under specified conditions, returns principal to investors prior to the expected payment dates and generally is a result of a deteriorating portfolio. The securitized, off-balance sheet assets are to be converted to an on-balance sheet credit equivalent amount using the 100 percent conversion factor and assigned to the 20 percent risk category. However, this capital requirement, when combined with the capital requirements for any retained recourse or direct credit substitute associated with the securitized assets, is limited to a total of 8 percent of the off-balance sheet securitized assets.

c. *Limitations on risk-based capital requirements.* (i) *Low-level exposure.* If the maximum contractual liability or exposure to loss retained or assumed by a bank in connection with a recourse obligation or a direct credit substitute is less than the effective risk-based capital requirement for the enhanced assets, the risk-based capital requirement is limited to the maximum contractual liability or exposure to loss, less any liability account established in accordance with generally accepted accounting principles. This limitation does not apply to assets sold with implicit recourse.

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

(iii) *Related on-balance sheet assets.* If a recourse obligation or direct credit substitute subject to section *III*.B.3. of this appendix A also appears as a balance sheet asset, the balance sheet asset is not included in a bank's risk-weighted assets to the extent the value of the balance sheet asset is already included in the off-balance sheet credit equivalent amount for the recourse obligation or direct credit substitute, except in the case of loan servicing assets and similar arrangements with embedded recourse obligations or direct credit substitutes. In the latter cases, both the on-balance sheet assets and the related recourse obligations and direct credit substitutes are incorporated into the risk-based capital calculation.

* * * * *

C. * * *

4. *Category 4: 100 percent.* a. All assets not included in the categories above are assigned to this category, which comprises standard risk assets. The bulk of the assets typically found in a loan portfolio would be assigned to the 100 percent category.

b. This category includes long-term claims on, and the portions of long-term claims that are guaranteed by, non-OECD banks, and all claims on non-OECD central governments that entail some degree of transfer risk.[36] This category includes all claims on foreign and domestic private-sector obligors not included in the categories above (including loans to nondepository financial institutions and bank holding companies); claims on commercial firms owned by the public sector; customer liabilities to the bank on acceptances outstanding involving standard risk claims;[37] investments in fixed assets, premises, and other real estate owned; common and preferred stock of corporations, including stock acquired for debts previously contracted; all stripped mortgage-backed securities and similar instruments; and commercial and consumer loans (except those assigned to lower risk categories due to recognized guarantees or collateral and loans secured by residential property that qualify for a lower risk weight).

c. Also included in this category are industrial-development bonds and similar obligations issued under the auspices of state or political subdivisions of the OECD-based group of countries for the benefit of a private party or enterprise where that party or enterprise, not the government entity, is obligated to pay the principal and interest, and all obligations of states or political subdivisions of countries that do not belong to the OECD-based group.

d. The following assets also are assigned a risk weight of 100 percent if they have not been deducted from capital: Investments in unconsolidated companies, joint ventures, or associated companies; instruments that qualify as capital issued by other banking organizations; and any intangibles, including those that may have been grandfathered into capital.

D. * * *

The face amount of an off-balance sheet item is generally incorporated into risk-weighted assets in two steps. The face amount is first multiplied by a credit

[36] Such assets include all nonlocal currency claims on, and the portions of claims that are guaranteed by, non-OECD central governments and those portions of local currency claims on, or guaranteed by, non-OECD central governments that exceed the local currency liabilities held by subsidiary depository institutions.

[37] Customer liabilities on acceptances outstanding involving nonstandard risk claims, such as claims on U.S. depository institutions, are assigned to the risk category appropriate to the identity of the obligor or, if relevant, the nature of the collateral or guarantees backing the claims. Portions of acceptances conveyed as risk participations to U.S. depository institutions or foreign banks are assigned to the 20 percent risk category appropriate to short-term claims guaranteed by U.S. depository institutions and foreign banks.

conversion factor, except for direct credit substitutes and recourse obligations as discussed in section III.D.1. of this appendix A. The resultant credit equivalent amount is assigned to the appropriate risk category according to the obligor or, if relevant, the guarantor or the nature of the collateral.[38] Attachment IV to this appendix A sets forth the conversion factors for various types of off-balance sheet items.

1. *Items with a 100 percent conversion factor.* a. Except as otherwise provided in section *III*.B.3. of this appendix A, the full amount of an asset or transaction supported, in whole or in part, by a direct credit substitute or a recourse obligation. Direct credit substitutes and recourse obligations are defined in section *III*.B.3. of this appendix A.

b. Sale and repurchase agreements and forward agreements. Forward agreements are legally binding contractual obligations to purchase assets with certain drawdown at a specified future date. Such obligations include forward purchases, forward forward deposits placed,[39] and partly-paid shares and securities; they do not include commitments to make residential mortgage loans or forward foreign exchange contracts.

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

d. In the case of direct credit substitutes in which a risk participation[40] has been conveyed, the full amount of the assets that are supported, in whole or in part, by the credit enhancement are converted to a credit equivalent amount at 100 percent. However, the *pro rata* share of the credit equivalent amount that has been conveyed through a risk participation is assigned to whichever risk category is lower: the risk category appropriate to the obligor, after considering any relevant guarantees or collateral, or the risk category appropriate to the institution acquiring the participation.[41] Any remainder is assigned to the risk category appropriate to the obligor, guarantor, or collateral. For example, the *pro rata* share of the full amount of the assets supported, in whole or in part, by a direct credit substitute conveyed as a risk participation to a U.S. domestic depository institution or foreign bank is assigned to the 20 percent risk category.[42]

e. In the case of direct credit substitutes in which a risk participation has been acquired, the acquiring bank's percentage share of the direct credit substitute is multiplied by the full amount of the assets that are supported, in whole or in part, by the credit enhancement and converted to a credit equivalent amount at 100 percent. The credit equivalent amount of an acquisition of a risk participation in a direct credit substitute is assigned to the risk category appropriate to the account party obligor or, if relevant, the nature of the collateral or guarantees.

f. In the case of direct credit substitutes that take the form of a syndication where each bank is obligated only for its *pro rata* share of the risk and there is no recourse to the originating bank, each bank will only include its *pro rata* share of the assets supported, in whole or in part, by the direct credit substitute in its risk-based capital calculation.[43]

* * * * *

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

1. The authority citation for part 225 continues to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1828(o), 1831i, 1831p–1, 1843(c)(8), 1844(b), 1972(1), 3106, 3108, 3310, 3331–3351, 3907, and 3909.

2. In appendix A to part 225:

A. The three introductory paragraphs to section II. are revised;

B. A new fifth undesignated paragraph is added to section III.*A.*;

C. In section III.*B.*, paragraph 3 is revised and footnote 26 is removed, and in paragraph 4 footnote 27 is removed;

D. In section III.*C.*, paragraphs 1 through 3, footnotes 28 through 40 are redesignated as footnotes 26 through 38, and paragraph 4 is revised;

E. In section III.*D.*, the introductory paragraph and paragraph 1 are revised; and

F. In section III.*D.* and III.*E.*, footnote 50 is removed and footnotes 51 through 57 are redesignated as footnotes 47 through 53.

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

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II. * * *

An institution's qualifying total capital consists of two types of capital components: ''core capital elements'' (comprising Tier 1 capital) and ''supplementary capital elements'' (comprising Tier 2 capital). These capital elements and the various limits, restrictions, and deductions to which they are subject, are discussed below and are set forth in Attachment II.

The Federal Reserve will, on a case-by-case basis, determine whether, and if so how much of, any liability that does not fit wholly within the terms of one of the capital categories set forth below or that does not have an ability to absorb losses commensurate with the capital treatment otherwise specified below will be counted as an element of Tier 1 or Tier 2 capital. In making such a determination, the Federal Reserve will consider the similarity of the liability to liabilities explicitly treated in the guidelines, the ability of the liability to absorb losses while the institution operates as a going concern, the maturity and redemption features of the liability, and other relevant terms and factors. To qualify as an element of Tier 1 or Tier 2 capital, a capital instrument may not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices.

Redemptions of permanent equity or other capital instruments before stated maturity could have a significant impact on an organization's overall capital structure. Consequently, an organization considering such a step should consult with the Federal Reserve before redeeming any equity or debt capital instrument (prior to maturity) if such redemption could have a material effect on the level or composition of the organization's capital base.[5]

* * * * *

III. * * *

A. * * *

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

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

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

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

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

[43] For example, if a bank has a 10 percent share of a $10 syndicated direct credit substitute that provides credit support to a $100 loan, then the bank's $1 *pro rata* share in the enhancement means that a $10 *pro rata* share of the loan is included in risk weighted assets.

[5] Consultation would not ordinarily be necessary if an instrument were redeemed with the proceeds of, or replaced by, a like amount of a similar or higher quality capital instrument and the organization's capital position is considered fully adequate by the Federal Reserve. In the case of limited-life Tier 2 instruments, consultation would generally be obviated if the new security is of equal or greater maturity than the one it replaces.

The Federal Reserve will, on a case-by-case basis, determine the appropriate risk weight for any asset or the credit equivalent amount of an off-balance sheet item that does not fit wholly within the terms of one of the risk weight categories set forth below or that imposes risks on a bank that are incommensurate with the risk weight otherwise specified below for the asset or off-balance sheet item. In addition, the Federal Reserve will, on a case-by-case basis, determine the appropriate credit conversion factor for any off-balance sheet item that does not fit wholly within the terms of one of the credit conversion factors set forth below or that imposes risks on an institution that are incommensurate with the credit conversion factors otherwise specified below for the off-balance sheet item. In making such a determination, the Federal Reserve will consider the similarity of the asset or off-balance sheet item to assets or off-balance sheet items explicitly treated in the guidelines, as well as other relevant factors.

B. * * *

3. *Recourse obligations, direct credit substitutes, and asset-and mortgage-backed securities.* Direct credit substitutes, assets transferred with recourse, and securities issued in connection with asset securitizations and structured financings are treated as described below. Use of the term ''asset securitizations'' or ''securitizations'' in this rule includes structured financings, as well as asset securitization transactions.

a. *Definitions.* (i) *Credit derivatives* are on- or off-balance sheet notes or contracts that allow one party (the ''beneficiary'') to transfer the credit risk of a ''reference asset,'' which it often owns, to another party (the ''guarantor''). The value of a credit derivative is dependent, at least in part, on the credit performance of the reference asset, which typically is a publicly traded loan or corporate bond.

(ii) *Credit-enhancing representations and warranties* means representations and warranties extended by a bank when it transfers assets (including loan servicing assets) or assumed by the bank when it purchases loan servicing assets that obligate the bank to absorb credit losses on transferred assets or serviced loans. These representations and warranties typically arise when the bank agrees to protect purchasers or some other party from losses due to the default or nonperformance of the obligor on the transferred assets or serviced loans, or insufficiency in the value of collateral supporting the transferred assets or serviced loans.

(iii) *Direct credit substitute* means an arrangement in which a banking organization *assumes,* in form or in substance, any risk of credit loss directly or indirectly associated with a *third-party* asset or other financial claim, that exceeds the banking organization's *pro rata* share of the asset or claim. If the banking organization has no claim on the asset, then the assumption of *any* risk of loss is a direct credit substitute. Direct credit substitutes include, but are not limited to:

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

(*2*) Guarantees, surety arrangements, credit derivatives, and irrevocable guarantee-type instruments backing financial claims such as outstanding securities, loans, or other financial liabilities, or that back off-balance sheet items against which risk-based capital must be maintained;

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

(*4*) Loans or lines of credit that provide credit enhancement for the financial obligations of an account party; and

(*5*) Purchased loan servicing assets if the servicer is responsible for credit losses associated with the loans being serviced (other than mortgage servicer cash advances as defined in paragraph III.*B*.3.a.(vi) of this appendix A), or if the servicer makes or assumes credit-enhancing representations and warranties with respect to the serviced loans.

(iv) *Externally rated* means, with respect to an instrument or obligation, that the instrument or obligation has received a credit rating from a nationally-recognized statistical rating organization.

(v) *Financial guarantee-type standby letter of credit* means any letter of credit or similar arrangement, however named or described, that represents an irrevocable obligation to the beneficiary on the part of the issuer:

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

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

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

(vii) *Nationally recognized statistical rating organization* means an entity recognized by the Division of Market Regulation of the Securities and Exchange Commission as a nationally recognized statistical rating organization for various purposes, including the Commission's uniform net capital requirements for brokers and dealers (17 CFR 240.15c3–1(c)(2)(vi)(E), (F), and (H)).

(viii) *Recourse* means an arrangement in which a banking organization *retains,* in form or in substance, any risk of credit loss directly or indirectly associated with a transferred asset that exceeds a *pro rata* share of the banking organization's claim on the asset. If a banking organization has no claim on a transferred asset, then the retention of any risk of loss is recourse. A recourse obligation typically arises when an institution transfers assets and retains an obligation to repurchase the assets or absorb losses due to a default of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may exist implicitly where a banking organization provides credit enhancement beyond any contractual obligation to support assets it has sold. Recourse obligations include, but are not limited to:

(*1*) Credit-enhancing representations and warranties on the transferred assets that obligate the servicer to absorb credit losses, including early-default clauses;

(*2*) Retained loan servicing assets if the servicer is responsible for losses associated with the loans being serviced other than mortgage servicer cash advances as defined in paragraph III.*B*.3.a.(v) of this appendix A.

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

(*4*) Assets sold under an agreement to repurchase if the assets are not already included on the balance sheet; and

(*5*) Loan strips sold without direct recourse where the maturity of the transferred loan that is drawn is shorter than the maturity of the commitment.

(ix) *Securitization* means the pooling and repackaging of loans or other credit exposures into securities that can be sold to investors. For purposes of this appendix A, securitization also includes structured finance transactions or programs that generally create stratified credit risk positions, whether in the form of a security or not, whose performance is dependent upon an underlying pool of credit exposures, including loans and commitments.

(x) *Traded position* means a recourse obligation, direct credit substitute, or asset- or mortgage-backed security that is retained, assumed, or issued in connection with an asset securitization and that is rated with a reasonable expectation that, in the near future:

(*1*) The position would be sold to investors relying on the rating; or

(*2*) A third party would, in reliance on the rating, enter into a transaction such as a purchase, loan, or repurchase agreement involving the position.

b. *Amount of position to be included in risk-weighted assets.* Types of recourse obligations or direct credit substitutes, other than those listed in section III.B.3.b.(i)(*1*) through (*7*) of this appendix A, should be treated in accordance with the principles contained in section III.*B*.3 of this appendix A. The treatment of direct credit substitutes that have been syndicated or in which risk participations have been conveyed or acquired is set forth in section III.*D*.1 of this appendix A.

(i) *General rule for determining the credit equivalent amount and risk weight of recourse obligations and direct credit substitutes.* Except as otherwise provided in section III of this appendix A, the risk weighted asset amount or the credit equivalent amount for a recourse obligation or direct credit substitute is the full amount of the credit enhanced assets from which risk of credit loss is directly or indirectly retained or assumed. This credit equivalent amount is assigned to the risk weight category appropriate to the obligor or, if relevant, the guarantor or nature of any collateral. Thus, a banking organization that extends a partial direct credit substitute, *e.g.,* a financial standby letter of credit, that absorbs the first 10 percent of loss on a transaction, must maintain capital against the full amount of the assets being supported. Furthermore, for direct credit substitutes that are on-balance sheet assets, *e.g.,* purchased subordinated securities, banking organizations must maintain capital against the amount of the direct credit substitutes and the full amount of the assets being supported, *i.e.,* all more senior positions. This treatment is subject to the low-level capital rule discussed in section III.*B*.3.c.(i) of this appendix A. For purposes of this appendix A, the full amount of the credit enhanced assets from which risk of credit loss is directly or indirectly retained or assumed means for:

(*1*) A financial guarantee-type standby letter of credit, surety arrangement, credit derivative, guarantee, or irrevocable guarantee-type instruments, the full amount of the assets that the direct credit substitute fully or partially supports;

(*2*) A subordinated interest or security, the amount of the subordinated interest or security plus all more senior interests or securities;

(*3*) Mortgage servicing assets that are recourse obligations or direct credit substitutes, the outstanding amount of the loans serviced;

(*4*) Credit-enhancing representations and warranties, the amount of the assets subject to the representations or warranties;

(*5*) Loans or lines of credit that provide credit enhancement for the financial obligations of an account party, the full amount of the enhanced financial obligations;

(*6*) Loans strips, the amount of the loans; and

(*7*) For assets sold with recourse, the amount of assets for which risk of loss is directly or indirectly retained, less any applicable recourse liability account established in accordance with generally accepted accounting principles.

(ii) *Determining the credit risk weight of recourse obligations, direct credit substitutes, and asset- and mortgage-backed securities that are rated within one of the five highest rating categories.* (*1*) A traded position is eligible for the risk-based capital treatment described in this paragraph if its external rating is within one of the five highest rating categories, *e.g.* AAA through BB, used by a nationally-recognized statistical rating organization. A recourse obligation, direct credit substitute, or asset- or mortgage-backed security which is not externally rated but is senior in all respects to a traded position that is externally rated, including access to any collateral, is also eligible for the risk-based capital treatment described in this paragraph III.*B*.3.b.(ii) as if it had the same rating as the traded position. This treatment for the unrated senior position is subject to current and prospective supervisory guidance on a case-by-case basis.

(*A*) *Two highest investment grades.* Except as otherwise provided in this section III. of this appendix A, the face amount of a recourse obligation, direct credit substitute, or an asset- or mortgage-backed security that is rated in either of two highest investment grade categories, *e.g.,* AAA or AA, is assigned to the 20 percent risk category.

(*B*) *Third highest investment grade.* Except as otherwise provided in this section III. of this appendix A, the face amount of a recourse obligation, direct credit substitute, or an asset- or mortgage-backed security that is rated in the third highest investment grade category, *e.g.,* A, is assigned to the 50 percent risk category.

(*C*) *Lowest investment grade.* Except as otherwise provided in this section III. of this appendix A, the face amount of a recourse obligation, direct credit substitute, or an asset- or mortgage-backed security that is rated in the lowest investment grade category, *e.g.,* BBB, is assigned to the 100 percent risk category.

(*D*) *One category below investment grade.* Except as otherwise provided in this section III. of this appendix A, the face amount of a recourse obligation, direct credit substitute, or an asset- or mortgage-backed security that is rated in the next lower category below the lowest investment grade category, *e.g.,* BB, is assigned to the 200 percent risk category.

(*2*) Nontraded recourse obligations, direct credit substitutes, or asset- or mortgage-backed securities that are retained, assumed, or issued in connection with an asset securitization are also eligible for the treatment described in this paragraph III.*B*.3.b.(ii) if they are externally rated within one of the five highest rating categories by two nationally-recognized statistical rating organizations, the ratings are publicly available, and the ratings are based on the same criteria used to rate securities sold to the public.

(*3*) A direct credit substitute extended in connection with an asset securitization that is not a traded position and is not externally rated by a nationally-recognized statistical rating organization (such as a letter of credit) may be eligible for the treatment described in paragraph III.*B*.3.b.ii(1)(*C*) and (*D*), *i.e., a minimum risk weight of 100 percent,* if it satisfies the criteria of one of the following approaches deemed appropriate for the organization by the Federal Reserve:

(*A*) A banking organization, under its qualifying internal risk rating system, assigns an internal rating to a direct credit substitute extended to an asset-backed commercial paper program that is equivalent to an external credit rating one category below investment grade or higher provided by a nationally recognized statistical rating organization. A qualifying internal risk rating system must be reviewed and deemed appropriate by the Federal Reserve and must satisfy the following criteria and any other prudential standards that the Federal Reserve determines are necessary. Qualifying internal risk rating systems at a minimum must:

(*i*) Be an integral part of an effective risk management system that explicitly incorporates the full range of risks arising from a banking organization's participation in securitization activities;

(*ii*) Link the internal ratings to measurable outcomes, such as the probability that the position will experience any loss, the position's expected loss given default, and the degree of variance in losses given default on that position;

(*iii*) Separately consider the risk associated with the underlying loans or borrowers, and the risk associated with the structure of a particular securitization transaction;

(*iv*) Identify gradations of risk among ''pass'' assets and other risk positions;

(*v*) Have clear, explicit criteria that are used to classify assets into each internal risk grade, including subjective factors;

(*vi*) Have independent credit risk management or loan review personnel assigning or reviewing the credit risk ratings;

(*vii*) Have an internal audit procedure that periodically verifies that the internal credit risk ratings are assigned in accordance with the established criteria;

(*viii*) Monitor the performance of the internal ratings assigned to nonrated nontraded direct credit substitutes over time to determine the appropriateness of the initial rating assignment and adjust individual ratings accordingly; and,

(*ix*) Be consistent with, or more conservative than, the rating assumptions and methodologies of nationally recognized statistical rating organizations.

(*B*) A banking organization's direct credit substitute extended to a securitization or structured finance program is reviewed by a nationally recognized statistical rating organization, in conjunction with a review of the overall program, and is assigned a rating or its equivalent. If the program has options for different combinations of assets, standards, internal credit enhancements, and other relevant factors, the rating organization may specify ranges of rating categories that may apply premised on which options are utilized by the bank's risk position. The banking organization must demonstrate to the Federal Reserve that the nationally recognized statistical rating organization's programmatic rating for its risk position generally meets the same standards used by the rating organization for rating traded positions, and that the rating organization's underlying premises are satisfied for particular direct credit substitutes issued by the institution. If a banking organization participates in a securitization or structured finance program sponsored by another party, the Federal Reserve may authorize the institution to use this approach based on a programmatic rating obtained by the sponsor of the program.

(*C*) An institution may rate its credit risk exposure to direct credit substitutes by relying on a qualifying credit assessment computer program. A nationally recognized statistical rating agency or other acceptable third party must have developed such a credit assessment system for determining the credit risk of direct credit substitutes and other stratified credit positions. Institutions must demonstrate to the Federal Reserve that ratings under such a credit assessment computer program correspond credibly and reliably with the ratings assigned by the rating agencies to publicly traded securities.

(iii) *Determining the credit risk weight for off-balance sheet securitized assets that are subject to early amortization provisions.* If a bank securitizes revolving assets, such as credit cards, home equity lines, or commercial loans issued under lines of credit, in a securitization transaction that it has sponsored and which includes early amortization provisions, then the sponsoring bank must maintain risk-based capital against the off-balance sheet securitized assets from the inception of the transaction. An early amortization feature is a provision that, under specified conditions, returns principal to investors prior to the expected payment dates and generally is a result of a deteriorating portfolio. The securitized, off-balance sheet assets are to be converted to an on-balance sheet credit equivalent amount using the 100 percent conversion factor and assigned to the 20 percent risk category. However, this capital requirement, when conbined with the capital requirements for any retained recourse or direct credit substitute associated with the securitized assets, is limited to a toal of 8 percent of the off-balance sheet securitized assets.

c. *Limitations on risk-based capital requirements.* (i) *Low-level exposure.* If the maximum contractual liability or exposure to loss retained or assumed by a banking organization in connection with a recourse obligation or a direct credit substitute is less than the effective risk-based capital requirement for the enhanced assets, the risk-based capital requirement is limited to the maximum contractual liability or exposure to loss, less any recourse liability account established in accordance with generally accepted accounting principles. This limitation does not apply to assets sold with implicit recourse.

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

(iii) *Related on-balance sheet assets.* If a recourse obligation or direct credit substitute subject to section III.*B*.3. of this appendix A also appears as a balance sheet asset, the balance sheet asset is not included in a banking organization's risk-weighted assets to the extent the value of the balance sheet asset is already included in the off-balance sheet credit equivalent amount for the recourse obligation or direct credit substitute, except in the case of loan servicing assets and similar arrangements with embedded recourse obligations or direct credit substitutes. In the latter cases, both the on-balance sheet assets and the related recourse obligations and direct credit substitutes are incorporated into the risk-based capital calculation.

* * * * *

C. * * *

4. *Category 4: 100 percent.* a. All assets not included in the categories above are assigned to this category, which comprises standard risk assets. The bulk of the assets typically found in a loan portfolio would be assigned to the 100 percent category.

b. This category includes long-term claims on, and the portions of long-term claims that are guaranteed by, non-OECD banks, and all claims on non-OECD central governments that entail some degree of transfer risk.[39] This category includes all claims on foreign and domestic private-sector obligors not included in the categories above (including loans to nondepository financial institutions and bank holding companies); claims on commercial firms owned by the public sector; customer liabilities to the bank on acceptances outstanding involving standard risk claims;[40] investments in fixed assets, premises, and other real estate owned; common and preferred stock of corporations, including stock acquired for debts previously contracted; all stripped mortgage-backed securities and similar instruments; and commercial and consumer loans (except those assigned to lower risk categories due to recognized guarantees or collateral and loans secured by residential property that qualify for a lower risk weight).

c. Also included in this category are industrial-development bonds and similar obligations issued under the auspices of state or political subdivisions of the OECD-based group of countries for the benefit of a private party or enterprise where that party or enterprise, not the government entity, is obligated to pay the principal and interest, and all obligations of states or political subdivisions of countries that do not belong to the OECD-based group.

d. The following assets also are assigned a risk weight of 100 percent if they have not been deducted from capital: investments in unconsolidated companies, joint ventures, or associated companies; instruments that qualify as capital issued by other banking organizations; and any intangibles, including those that may have been grandfathered into capital.

D. * * *

The face amount of an off-balance sheet item is generally incorporated into risk-weighted assets in two steps. The face amount is first multiplied by a credit conversion factor, except for direct credit substitutes and recourse obligations as discussed in section III.*D*.1. of this appendix A. The resultant credit equivalent amount is assigned to the appropriate risk category according to the obligor or, if relevant, the guarantor or the nature of the collateral.[41] Attachment IV to this appendix A sets forth the conversion factors for various types of off-balance sheet items.

1. *Items with a 100 percent conversion factor.* a. Except as otherwise provided in section III.*B*.3. of this appendix A, the full amount of an asset or transaction supported, in whole or in part, by a direct credit substitute or a recourse obligation. Direct credit substitutes and recourse obligations are defined in section III.*B*.3. of this appendix A. b. Sale and repurchase agreements and forward agreements. Forward agreements are legally binding contractual obligations to purchase assets with certain drawdown at a specified future date. Such obligations include forward purchases, forward forward deposits placed,[42] and partly-paid shares and securities; they do not include commitments to make residential mortgage loans or forward foreign exchange contracts.

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

d. In the case of direct credit substitutes in which a risk participation[43] has been conveyed, the full amount of the assets that

[39] Such assets include all nonlocal currency claims on, and the portions of claims that are guaranteed by, non-OECD central governments and those portions of local currency claims on, or guaranteed by, non-OECD central governments that exceed the local currency liabilities held by subsidiary depository institutions.

[40] Customer liabilities on acceptances outstanding involving nonstandard risk claims, such as claims on U.S. depository institutions, are assigned to the risk category appropriate to the identity of the obligor or, if relevant, the nature of the collateral or guarantees backing the claims. Portions of acceptances conveyed as risk participations to U.S. depository institutions or foreign banks are assigned to the 20 percent risk category appropriate to short-term claims guaranteed by U.S. depository institutions and foreign banks.

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

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

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

are supported, in whole or in part, by the credit enhancement are converted to a credit equivalent amount at 100 percent. However, the *pro rata* share of the credit equivalent amount that has been conveyed through a risk participation is assigned to whichever risk category is lower: the risk category appropriate to the obligor, after considering any relevant guarantees or collateral, or the risk category appropriate to the institution acquiring the participation.[44] Any remainder is assigned to the risk category appropriate to the obligor, guarantor, or collateral. For example, the *pro rata* share of the full amount of the assets supported, in whole or in part, by a direct credit substitute conveyed as a risk participation to a U.S. domestic depository institution or foreign bank is assigned to the 20 percent risk category.[45]

e. In the case of direct credit substitutes in which a risk participation has been acquired, the acquiring banking organization's percentage share of the direct credit substitute is multiplied by the full amount of the assets that are supported, in whole or in part, by the credit enhancement and converted to a credit equivalent amount at 100 percent. The credit equivalent amount of an acquisition of a risk participation in a direct credit substitute is assigned to the risk category appropriate to the account party obligor or, if relevant, the nature of the collateral or guarantees.

f. In the case of direct credit substitutes that take the form of a syndication where each banking organization is obligated only for its *pro rata* share of the risk and there is no recourse to the originating banking organization, each banking organization will only include its *pro rata* share of the assets supported, in whole or in part, by the direct credit substitute in its risk-based capital calculation.[46]

* * * * *

By order of the Board of Governors of the Federal Reserve System, February 10, 2000.

Jennifer J. Johnson,

Secretary of the Board.

Federal Deposit Insurance Corporation

12 CFR Chapter III

Authority and Issuance

For the reasons set forth in the joint preamble, part 325 of chapter III of title 12 of the Code of Federal Regulations is proposed to be amended as follows:

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

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

[46] For example, if a banking organization has a 10 percent share of a $10 syndicated direct credit substitute that provides credit support to a $100 loan, then the banking organization's $1 *pro rata* share in the enhancement means that a $10 *pro rata* share of the loan is included in risk weighted assets.

PART 325—CAPITAL MAINTENANCE

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

Authority: 12 U.S.C. 1815(a), 1815(b), 1816, 1818(a), 1818(b), 1818(c), 1818(t), 1819(Tenth), 1828(c), 1828(d), 1828(i), 1828(n), 1828(o), 1831o, 1835, 3907, 3909, 4808; Pub. L. 102–233, 105 Stat. 1761, 1789, 1790 (12 U.S.C. 1831n note); Pub. L. 102–242, 105 Stat. 2236, 2355, as amended by Pub. L. 103–325, 108 Stat. 2160, 2233 (12 U.S.C. 1828 note); Pub. L. 102–242, 105 Stat. 2236, 2386, as amended by Pub. L. 102–550, 106 Stat. 3672, 4089 (12 U.S.C. 1828 note).

2. In appendix A to part 325, section II:

A. In paragraph A., the first two undesignated paragraphs are designated 1. and 2. respectively;

B. A new paragraph A.3. is added;

C. Paragraph B. is amended by revising paragraph B.5.;

D. In paragraph C., Category 1—Zero Percent Risk Weight through Category 3—50 Percent Risk Weight, footnotes 15 through 31 are redesignated as footnotes 19 through 34;

E. In paragraph C., Category 2—20 Percent Risk Weight, the three undesignated paragraphs are designated as paragraphs a. through c., respectively, and a new paragraph d. is added;

F. In paragraph C., Category 3—50 Percent Risk Weight, the third undesignated paragraph is removed and the remaining three undesignated paragraphs are designated as paragraphs a. through c., respectively;

G. In paragraph C., Category 3—50 Percent Risk Weight, newly designated footnote 32 is revised;

H. In paragraph C., Category 4—100 Percent Risk Weight is revised;

I. In paragraph C., following the paragraph titled Category 4—100 Percent Risk Weight, a new paragraph titled Category 5—200 Percent Risk Weight is added;

J. In paragraph D., the undesignated introductory paragraph is revised;

K. Paragraph D.1. is revised;

L. In paragraph D.2., footnote 38 is removed; and

M. In paragraphs D.2. and E., footnotes 39 through 42 are redisignated as footnotes 38 through 41.

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

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II. * * *

A. * * *

3. The Director of the Division of Supervision may, on a case-by-case basis, determine the appropriate risk weight for any asset or credit equivalent amount that does not fit wholly within one of the risk categories set forth below or that imposes risks on a bank that are not commensurate with the risk weight otherwise specified below for the asset or credit equivalent amount. In addition, the Director of the Division of Supervision may, on a case-by-case basis, determine the appropriate credit conversion factor for any off-balance sheet item that does not fit wholly within one of the credit conversion factors set forth below or that imposes risks on a bank that are not commensurate with the credit conversion factor otherwise specified below for the off-balance sheet item. In making such a determination, the Director of the Division of Supervision will consider the similarity of the asset or off-balance sheet item to assets or off-balance sheet items explicitly treated in the guidelines, as well as other relevant factors.

B. * * *

5. *Recourse obligations, direct credit substitutes, and asset-and mortgage-backed securities.* Direct credit substitutes, assets sold with recourse, and securities issued in connection with asset securitizations are treated as described below.

(a) *Definitions.* (i) *Credit derivative* means an on-or off-balance sheet note or contract that allows one party (the "beneficiary") to transfer the credit risk of a "reference asset," which the beneficiary often owns, to another party (the "guarantor"). The value of a credit derivative is dependent, at least in part, on the credit performance of the reference asset, which typically is a publicly traded loan or corporate bond.

(ii) *Credit-enhancing representations and warranties* means representations and warranties, extended by a bank when it transfers assets (including loan servicing assets) or assumed by the bank when it purchases loan servicing assets, that obligate the bank to protect another party from losses due to credit risk in the transferred assets or serviced loans. These representations and warranties typically arise when the bank agrees to protect purchasers or some other party from losses due to:

(*1*) The default or nonperformance of the obligor on the transferred assets or serviced loans; or

(*2*) Insufficiency in the value of collateral supporting the transferred assets or serviced loans.

(iii) *Direct credit substitute* means an arrangement in which a bank *assumes,* in form or in substance, any risk of credit loss directly or indirectly associated with a *third-party* asset or other financial claim, that exceeds the bank's *pro rata* share of the asset or claim. If the bank has no claim on the asset, then the assumption of *any* risk of loss is a direct credit substitute. Direct credit substitutes include, but are not limited to:

(*1*) Financial standby letters of credit, which includes any letter of credit or similar arrangement, however named or described, that represents an irrevocable obligation to the beneficiary on the part of the issuer:

(*a*) To repay money borrowed by, advanced to, or for the account of, the account party, or

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

(*2*) Guarantees, surety arrangements, credit derivatives, and irrevocable guarantee-type instruments backing financial claims such as outstanding securities, loans, or other financial claims, or that back off-balance-sheet items against which risk-based capital must be maintained;

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

(*4*) Loans or lines of credit that provide credit enhancement for the financial obligations of an account party; and

(*5*) Purchased loan servicing assets if the servicer is responsible for credit losses associated with the loans being serviced (other than mortgage servicer cash advances as defined in paragraph B.5(a)(vi) of this section), or if the servicer makes or assumes credit-enhancing representations and warranties on the serviced loans.

(iv) *Externally rated* means, with respect to an instrument or obligation, that the instrument or obligation has received a credit rating from a nationally-recognized statistical rating organization.

(v) *Face amount* means the notional principal, or face value, amount of an off-balance sheet item; the amortized cost of an asset not held for trading purposes; and the fair value of a trading asset.

(vi) *Mortgage servicer cash advance* means funds that a residential mortgage loan servicer advances to ensure an uninterrupted flow of payments or the timely collection of residential mortgage loans, including disbursements made to cover foreclosure costs or other expenses arising from a mortgage loan to facilitate its timely collection, so long as the mortgage servicer is entitled to full reimbursement or nonreimbursable advances are contractually limited to an insignificant amount of the outstanding principal for any one residential mortgage loan, and the servicer's entitlement to reimbursement is not subordinated.

(vii) *Nationally recognized statistical rating organization* means an entity recognized by the Division of Market Regulation of the Securities and Exchange Commission as a nationally recognized statistical rating organization for various purposes, including the Commission's uniform net capital requirements for brokers and dealers (17 CFR 240.15c3–1(c)(2)(vi)(E), (F), and (H)).

(viii) *Recourse* means an arrangement in which a bank *retains*, in form or in substance, any risk of credit loss directly or indirectly associated with an asset it has transferred and sold that exceeds a *pro rata* share of the bank's claim on the asset. If a bank has no claim on an asset it has transferred and sold, then the retention of any risk of credit loss is recourse. A recourse obligation typically arises when an institution transfers assets in a sale and retains an obligation to repurchase the assets or absorb losses due to a default of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may exist implicitly where a bank provides credit enhancement beyond any contractual obligation to support assets it has sold. Recourse obligations include, but are not limited to:

(*1*) Credit-enhancing representations and warranties on the transferred assets;

(*2*) Retained loan servicing assets if the servicer is responsible for credit losses associated with the loans being serviced (including credit-enhancing representations and warranties), other than mortgage servicer cash advances as defined in paragraph B.5(a)(vi) of this section;

(*3*) Retained subordinated interests or securities, or credit derivatives that absorb more than their *pro rata* share of credit losses from the underlying assets;

(*4*) Assets sold under an agreement to repurchase, if the assets are not already included on the balance sheet; and

(*5*) Loan strips sold without direct recourse where the maturity of the transferred loan that is drawn is shorter than the maturity of the commitment.

(ix) *Securitization* means the pooling and repackaging of loans or other credit exposures into securities that can be sold to investors. For purposes of this section II.B.5, *securitization* also includes transactions or programs that generally create stratified credit risk positions, whether in the form of a security or not, whose performance is dependent upon an underlying pool of loans or other credit exposures.

(x) *Traded position* means a recourse obligation, direct credit substitute, or asset-or mortgage-backed security that is retained, assumed, or issued in connection with an asset securitization and that is externally rated with a reasonable expectation that, in the near future:

(*1*) The position would be sold to investors relying on the external rating; or

(*2*) A third party would, in reliance on the external rating, enter into a transaction such as a purchase, loan, or repurchase agreement involving the position.

(b) *Amount of position to be included in risk-weighted assets*—(i) *General rule for determining the credit equivalent amount and risk weight of recourse obligations and direct credit substitutes.* Except as otherwise provided in this section II.B. of this appendix A, the credit equivalent amount for a recourse obligation or direct credit substitute is the full amount of the credit enhanced assets from which risk of credit loss is directly or indirectly retained or assumed by the bank. This credit equivalent amount is assigned to the risk category appropriate to the obligor, or if relevant, the guarantor or nature of any collateral. Thus, a bank that extends a partial direct credit substitute, *e.g.,* a financial standby letter of credit that absorbs the first 10 percent of loss on a transaction, must maintain capital against the full amount of the assets being supported. Furthermore, for a direct credit substitute that is an on-balance sheet asset, *e.g.,* a purchased subordinated security, a bank must maintain capital against the amount of the direct credit substitute and the full amount of the assets being supported, *i.e.,* all more senior positions. This treatment is subject to the low-level exposure rule discussed in section II.B.5(c)(i) of this appendix A. For purposes of this appendix A, the full amount of the credit enhanced assets from which risk of credit loss is directly or indirectly retained or assumed means for:

(*1*) A financial standby letter of credit, surety arrangement, credit derivative, guarantee, or irrevocable guarantee-type instrument, the full amount of the assets that the direct credit substitute fully or partially supports;

(*2*) A subordinated interest or security, the amount of the subordinated interest or security plus all more senior interests or securities;

(*3*) Loan servicing assets that are recourse obligations or direct credit substitutes, the outstanding amount of the loans serviced;

(*4*) Credit-enhancing representations and warranties, the amount of the assets subject to the representations or warranties;

(*5*) Loans or lines of credit that provide credit enhancement for the financial obligations of an account party, the full amount of the enhanced financial obligations;

(*6*) Loans strips, the amount of the loans sold; and

(*7*) Assets sold with recourse, the full amount of the assets from which risk of credit loss is directly or indirectly retained, less any applicable recourse liability account established in accordance with generally accepted accounting principles.

(ii) *Participations in and syndications of direct credit substitutes.* Subject to the low-level exposure rule discussed in section II.B.5(c)(i) of this appendix A:

(*1*) In the case of a direct credit substitute in which the bank has conveyed a risk participation,[14] the full amount of the assets that are supported, in whole or in part, by the direct credit substitute are converted to a credit equivalent amount at 100 percent. However, the *pro rata* share of the credit equivalent amount that has been conveyed through a risk participation is assigned to whichever risk category is lower: The risk category appropriate to the obligor, after considering any relevant guarantees or collateral, or the risk category appropriate to the institution acquiring the participation.[15] Any remainder is assigned to the risk category appropriate to the obligor, guarantor, or collateral. For example, the *pro rata* share of the full amount of the assets supported, in whole or in part, by a direct credit substitute conveyed as a risk participation to a U.S. domestic depository institution or an OECD bank is assigned to the 20 percent risk category.[16]

(*2*) In the case of a direct credit substitute in which the bank has acquired a risk participation, the acquiring bank's percentage share of the direct credit substitute is multiplied by the full amount of the assets that are supported, in whole or in part, by the direct credit substitute and converted to a credit equivalent amount at 100 percent. The resulting credit equivalent amount is

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

[15] A risk participation in a bankers acceptance conveyed to another institution is also assigned to the risk category appropriate to the institution acquiring the participation or, if relevant, the guarantor or nature of the collateral.

[16] A risk participation with a remaining maturity of one year or less that is conveyed to a non-OECD bank is also assigned to the 20 percent risk category.

assigned to the risk category appropriate to the account party obligor, guarantor, or collateral.

(*3*) In the case of a direct credit substitute that takes the form of a syndication where each bank is obligated only for its *pro rata* share of the risk and there is no recourse to the originating bank, each bank's credit equivalent amount will be only its *pro rata* share of the assets supported, in whole or in part, by the direct credit substitute. The resulting credit equivalent amount is assigned to the risk category appropriate to the obligor, guarantor, or collateral. [17]

(iii) *Face-amount treatment for externally rated recourse obligations, direct credit substitutes, and asset-and mortgage-backed securities.* (*1*) A traded position is eligible for the risk-based capital treatment described in this paragraph II.B.5(b)(iii) if its external rating is within one of the five highest rating categories, *e.g.,* AAA through BB, used by a nationally-recognized statistical rating organization.

(*a*) *Two highest investment grades.* The face amount of a recourse obligation, direct credit substitute, or an asset-or mortgage-backed security that is rated in either of the two highest investment grade categories, *e.g.,* AAA or AA, is assigned to the 20 percent risk category.

(*b*) *Third highest investment grade.* The face amount of a recourse obligation, direct credit substitute, or an asset-or mortgage-backed security that is rated in the third highest investment grade category, *e.g.,* A, is assigned to the 50 percent risk category.

(*c*) *Lowest investment grade.* The face amount of a recourse obligation, direct credit substitute, or an asset-or mortgage-backed security that is rated in the lowest investment grade category, *e.g.,* BBB, is assigned to the 100 percent risk category.

(*d*) *One category below investment grade.* The face amount of a recourse obligation, direct credit substitute, or an asset- or mortgage-backed security that is rated in the next lower category below the lowest investment grade category, *e.g.,* BB, is assigned to the 200 percent risk category.

(*2*) Other recourse obligations and direct credit substitutes that are retained, assumed, or issued in connection with an asset securitization are also eligible for the risk-based capital treatment described in this paragraph II.B.5(b)(iii) if they are externally rated by two nationally-rated statistical rating organizations as falling within one of the five highest rating categories used by the organizations, the ratings are publicly available, and the ratings are based on the same criteria used to rate traded positions.[18] If the two ratings differ, the lower rating will determine the risk category to which the recourse obligation or direct credit substitute will be assigned.

(*3*) Stripped mortgage-backed securities (such as interest-only or principal-only strips) may not be assigned to the 20 percent or 50 percent risk category under section II.B.5(b)(iii)(1)(a)–(b) of this appendix A.

(*4*) A position which is not externally rated but is senior in all respects to a traded position eligible for the risk-based capital treatment described in section II.B.5(b)(iii)(*1*) of this appendix A, including access to any collateral, will be eligible for the risk-based capital treatment described in this paragraph II.B.5(b)(iii) as if it had the same rating as the traded position, if the bank can demonstrate to the FDIC's satisfaction that such treatment is appropriate.

(iv) *Face-amount treatment for direct credit substitutes which are not externally rated.* A direct credit substitute assumed or issued in connection with an asset securitization which does not qualify for face amount treatment under section II.B.5(b)(iii) of this appendix A because it is not externally rated may still qualify for face amount treatment, if the bank determines that the credit risk of the direct credit substitute is equivalent to or better than the external rating category set out at section II.B.5(b)(iii)(*1*)(*d*) of this appendix A (*e.g.,* BB). The face amount of a position which the bank determines is equivalent to or better than the external rating category set out at section II.B.5(b)(iii)(*1*)(*c*) of this appendix A (*e.g.,* BBB) must be assigned to the 100 percent risk category, and a position equivalent to the external rating category set out in section II.B.5(b)(iii)(*1*)(*d*) of this appendix A (*e.g.,* BB) must be assigned to the 200 percent risk category. The bank's determination may only be made pursuant to the following three approaches, the use of which must be satisfactory to the FDIC:

(*1*) *Internal risk ratings for asset-backed commercial paper programs.* A bank, under its internal risk rating system, assigns an internal rating to a direct credit substitute the bank extends to the asset-backed commercial paper program it sponsors, and the rating is equivalent to or better than the rating category set out at section B.5(b)(iii)(*1*)(*d*) of this appendix A (*e.g.,* BB). The internal risk rating system must be satisfactory to the FDIC and must be prudent and appropriate for the size and complexity of the bank's program. Adequate internal risk rating systems typically:

(*a*) are an integral part of an effective risk management system that explicitly incorporates the full range of risks arising from a bank's participation in securitization activities;

(*b*) link the internal ratings to measurable outcomes, such as the probability that the position will experience any loss, the position's expected loss given default, and the degree of variance in losses given default on that position;

(*c*) separately consider the risk associated with the underlying loans or borrowers and the risk associated with the structure of a particular securitization transaction;

(*d*) identify gradations of risk among ''pass'' assets and other risk positions;

(*e*) have clear, explicit criteria that are used to classify assets into each internal risk grade, including criteria for subjective factors;

(*f*) have independent credit risk management or loan review personnel with adequate training assigning or reviewing the credit risk ratings, subject to internal audit review to verify that ratings are assigned in accordance with the bank's criteria;

(*g*) track the performance of the internal ratings over time and make adjustments to the ratings system when the performance of rated positions has a tendency to diverge from assigned ratings, and adjust individual ratings accordingly; and,

(*h*) are consistent with, or more conservative than, the rating assumptions and methodologies of nationally recognized statistical rating organizations.

(*2*) *Program ratings.* If a nationally recognized statistical rating organization or other entity satisfactory to the FDIC has reviewed the terms of a securitization program and stated a rating for direct credit substitutes to be issued under the program equivalent to or better than the external rating category set out at section II.B.5(b)(iii)(*1*)(*d*) of this appendix A (*e.g.,* BB), a bank may use such a rating for a direct credit substitute the bank issues under the program. If the program has options for different combinations of assets, standards, internal credit enhancements, and other relevant factors, the rating organization or other entity may specify ranges of rating categories that will apply premised on which options correspond to the bank's position. The bank must demonstrate to the FDIC's satisfaction that the program rating meets the same standards generally used by nationally recognized statistical rating organizations for rating traded positions, and that the rating organization's or other entity's underlying premises are satisfied for the particular direct credit substitute issued by the bank.

(*3*) *Credit assessment computer program.* A bank may use an acceptable credit assessment computer program to determine that a direct credit substitute is equivalent to or better than the external rating category set out at section II.B.5(b)(iii)(*1*)(*d*) of this appendix A (*e.g.,* BB). A nationally recognized statistical rating organization or other party satisfactory to the FDIC must have developed the credit assessment system for determining the credit risk of direct credit substitutes and other stratified credit positions. The bank must demonstrate to the FDIC's satisfaction that ratings under such a credit assessment computer program correspond credibly and reliably with the rating of traded positions.

(v) *Determining the credit risk weight for off-balance sheet securitized assets that are subject to early amortization provisions.* If a bank securitizes revolving assets, such as credit cards, home equity lines, or commercial lines of credit, in a transaction that it has sponsored and which includes early amortization provisions, then the bank must maintain risk-based capital against the off-balance sheet securitized assets from the inception of the transaction. An early amortization feature is a provision that, under specified conditions, returns principal to investors prior to the expected payment

[17] For example, if a bank has a 10 percent share of a $10 syndicated direct credit substitute that provides credit support to a $100 loan to a private obligor, then the bank's $1 *pro rata* share in the enhancement means that a $10 *pro rata* share of the loan is included in the bank's risk weighted assets.

[18] The bank must demonstrate to the FDIC's satisfaction that the ratings are based on the same criteria that the ratings organizations use to rate traded positions.

dates, generally as a result of a deterioration in the portfolio of securitized revolving assets. The securitized, off-balance sheet assets are to be converted to an on-balance sheet credit equivalent amount using the 100 percent conversion factor and the resulting amount is to be assigned to the 20 percent risk category. However, this capital requirement, when combined with the capital requirements for any retained recourse or direct credit substitute associated with the securitized assets, is limited to a total of 8 percent of the managed assets.

(c) *Limitations on risk-based capital requirements*—(i) *Low-level exposure.* If the maximum contractual liability or exposure to loss retained or assumed by a bank in connection with a recourse obligation or a direct credit substitute is less than the effective risk-based capital requirement for the enhanced assets, the risk-based capital requirement is limited to the maximum contractual liability or exposure to loss, less any recourse liability account established in accordance with generally accepted accounting principles. This limitation does not apply to assets sold with implicit recourse.

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

(iii) *Related on-balance sheet assets.* If a recourse obligation or direct credit substitute subject to paragraph B.5. of this section also appears as a balance sheet asset, the balance sheet asset is not included in a bank's risk-weighted assets to the extent the value of the balance-sheet asset is already included in the credit equivalent amount for the recourse obligation or direct credit substitute, except in the case of loan servicing assets and similar arrangements with embedded recourse obligations or direct credit substitutes. In such a case, both the on-balance sheet servicing assets and the related recourse obligations or direct credit substitutes are incorporated into the risk-based capital calculation.

* * * * *

C. * * *

Category 2—20 Percent Risk Weight.

* * * * *

d. This category also includes the credit equivalent amount of off-balance sheet securitized revolving assets in transactions which include early amortization provisions that were sponsored by the bank.

Category 3—50 Percent Risk Weight.

* * * * *

b. * * * [32] * * *

* * * * *

Category 4—100 Percent Risk Weight. (a) All assets not included in the categories above, except the assets specifically included in the 200 percent category below, are assigned to this category, which comprises standard risk assets. The bulk of the assets typically found in a loan portfolio would be assigned to the 100 percent category.

(b) This category includes:

(1) Long-term claims on, and the portions of long-term claims that are guaranteed by, non-OECD banks, and all claims on non-OECD central governments that entail some degree of transfer risk; [35]

(2) All claims on foreign and domestic private-sector obligors not included in the categories above (including loans to nondepository financial institutions and bank holding companies);

(3) Claims on commercial firms owned by the public sector;

(4) Customer liabilities to the bank on acceptances outstanding involving standard risk claims; [36]

(5) Investments in fixed assets, premises, and other real estate owned;

(6) Common and preferred stock of corporations, including stock acquired for debts previously contracted;

(7) Commercial and consumer loans (except those assigned to lower risk categories due to recognized guarantees or collateral and loans secured by residential property that qualify for a lower risk weight);

(8) Mortgage- and asset-backed securities that do not meet the criteria for assignment to a lower risk category;

(9) Industrial-development bonds and similar obligations issued under the auspices of states or political subdivisions of the OECD-based group of countries for the benefit of a private party or enterprise where that party or enterprise, not the government entity, is obligated to pay the principal and interest; and

(10) All obligations of states or political subdivisions of countries that do not belong to the OECD-based group.

(c) The following assets also are assigned a risk weight of 100 percent if they have not already been deducted from capital: investments in unconsolidated companies, joint ventures, or associated companies; instruments that qualify as capital issued by other banks; deferred tax assets; and mortgage servicing assets, nonmortgage servicing assets, and other allowed intangibles.

Category 5—200 Percent Risk Weight. This category includes:

(a) The face amount of externally rated recourse obligations, direct credit substitutes, and asset- and mortgage-backed securities that are rated in the next lower category below the lowest investment grade category, *e.g.,* BB, to the extent permitted in section II.B.5(b)(iii) of this appendix A; and

(b) The face amount of direct credit substitutes for which the bank determines that the credit risk is equivalent to one category below investment grade, *e.g.,* BB, to the extent permitted in section II.B.5.(b)(iii) of this appendix A.

D. * * *

The face amount of an off-balance sheet item is generally incorporated into the risk-weighted assets in two steps. The face amount is first multiplied by a credit conversion factor, except for direct credit substitutes and recourse obligations as discussed in section II.B.5. of this appendix A. The resultant credit equivalent amount is assigned to the appropriate risk category according to the obligor or, if relevant, the guarantor or the nature of the collateral.[37] Table III to this appendix A sets forth the conversion factors for various types of off-balance-sheet items.

1. Items with a 100 percent conversion factor. (a) Except as otherwise provided in section II.B.5. of this appendix A, the full amount of an asset or transaction supported, in whole or in part, by a direct credit substitute or a recourse obligation. Direct credit substitutes and recourse obligations are defined in section II.B.5. of this appendix A.

(b) Sale and repurchase agreements, if not already included on the balance sheet, and forward agreements. Forward agreements are legally binding contractual obligations to purchase assets with drawdown which is certain at a specified future date. Such obligations include forward purchases, forward forward deposits placed,[38] and partly-paid shares and securities; they do not include commitments to make residential mortgage loans or forward foreign exchange contracts.

(c) Securities lent by a bank are treated in one of two ways, depending upon whether

[32] The types of loans that qualify as loans secured by multifamily residential properties are listed in the instructions for preparation of the Consolidated Reports of Condition and Income. In addition, from the standpoint of the selling bank, when a multifamily residential property loan is sold subject to a *pro rata* loss sharing arrangement which provides for the purchaser of the loan to share in any loss incurred on the loan on a *pro rata* basis with the selling bank, that portion of the loan is not subject to the risk-based capital standards. In connection with sales of multifamily residential property loans in which the purchaser of the loan shares in any loss incurred on the loan with the selling institution on other than a *pro rata* basis, the selling bank must treat these other loss sharing arrangements in accordance with section II.B.5. of this appendix A.

[35] Such assets include all nonlocal currency claims on, and the portions of claims that are guaranteed by, non-OECD central governments and those portions of local currency claims on, or guaranteed by, non-OECD central governments that exceed the local currency liabilities held by the bank.

[36] Customer liabilities on acceptances outstanding involving nonstandard risk claims, such as claims on U.S. depository institutions, are assigned to the risk category appropriate to the identity of the obligor or, if relevant, the nature of the collateral or guarantees backing the claims. Portions of acceptances conveyed as risk participations to U.S. depository institutions or foreign banks are assigned to the 20 percent risk category appropriate to short-term claims guaranteed by U.S. depository institutions and foreign banks.

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

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

the lender is exposed to risk of loss. If a bank, as agent for a customer, lends the customer's securities and does not indemnify the customer against loss, then the securities transaction is excluded from the risk-based capital calculation. On the other hand, if a bank lends its own securities or, acting as agent for a customer, lends the customer's securities and indemnifies the customer against loss, the transaction is converted at 100 percent and assigned to the risk weight category appropriate to the obligor or, if applicable, to the collateral delivered to the lending bank or the independent custodian acting on the lending bank's behalf.

* * * * *

3. In the tables at the end of appendix A to part 325, Table II.—Summary of Risk Weights and Risk Categories:

A. In Category 2—20 Percent Risk Weight, paragraph (11) is removed, paragraph (12) is redesignated as paragraph (11), and new paragraphs (12) and (13) are added;

B. In Category 3—50 Percent Risk Weight, paragraph (3) is revised;

C. In Category 4—100 Percent Risk Weight, paragraph (9) is revised and a new paragraph (10) is added; and

D. Following the paragraph titled Category 4—100 Percent Risk Weight, a new paragraph titled, Category 5—200 Percent Risk Weight, is added to read as follows:

* * * * *

Table II.—Summary of Risk Weights and Risk Categories.

* * * * *

Category 2—20 Percent Risk Weight.

* * * * *

(12) Asset- or mortgage-backed securities (or recourse obligations or direct credit substitutes issued in connection with such securitizations) rated in either of the two highest investment grade categories, *e.g.,* AAA or AA.

(13) The credit equivalent amount of off-balance sheet revolving assets in securitization transactions featuring early amortization provisions sponsored by the bank.

Category 3—50 Percent Risk Weight.

* * * * *

(3) Asset- or mortgage-backed securities (or recourse obligations or direct credit substitutes issued in connection with such securitizations) rated in the third-highest investment grade category, *e.g.,* A.

* * * * *

Category 4—100 Percent Risk Weight.

* * * * *

(9) Asset- or mortgage-backed securities (or recourse obligations or direct credit substitutes issued in connection with such securitizations) rated in the lowest investment grade category, *e.g.,* BBB, as well as certain direct credit substitutes which the bank rates as the equivalent of the lowest investment grade category, *e.g.,* BBB, or above through an internal assessment satisfactory to the FDIC.

(10) All other assets, including any intangible assets that are not deducted from capital, and the credit equivalent amounts [4] of off-balance sheet items not assigned to a different risk category.

Category 5—200 Percent Risk Weight.

Asset- or mortgage-backed securities (or recourse obligations or direct credit substitutes issued in connection with such securitizations) rated one category below investment grade, *e.g.,* BB, as well as certain direct credit substitutes which the bank rates as the equivalent of one category below investment grade, *e.g.,* BB, through an internal assessment satisfactory to the FDIC.

4. In the tables at the end of appendix A to part 325, Table III.—Credit Conversion Factors for Off-Balance Sheet Items:

A. In this table, references to footnote 1 are removed each time they appear and footnote 1 is removed.

B. In 100 Percent Conversion Factor, paragraphs (1) through (3) are revised, and a new paragraph (6) is added, to read as follows:

Table III.—Credit Conversion Factors for Off-Balance Sheet Items.

100 Percent Conversion Factor.

(1) The full amount of assets supported by direct credit substitutes or recourse obligations (unless a different treatment is otherwise specified). For risk participations in such arrangements and acquired by the bank, the full amount of assets supported by the main obligation multiplied by the acquiring bank's percentage share of the risk participation.

(2) Acquisitions of risk participations in bankers acceptances.

(3) Sale and repurchase agreements, if not already included on the balance sheet.

* * * * *

(6) Off-balance sheet revolving assets in securitization transactions featuring early amortization provisions sponsored by the bank.

* * * * *

By Order of the Board of Directors.

Dated at Washington, DC this 9th day of February, 2000.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary.

Department of the Treasury

Office of Thrift Supervision

12 CFR Chapter V

Authority and Issuance

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

PART 567—CAPITAL

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

Authority: 12 U.S.C. 1462, 1462a, 1463, 1464, 1467a, 1828 (note).

2. Section 567.1 is amended by revising the definitions of direct credit substitute and recourse and adding definitions of covered representations and warranties, credit derivative, financial guarantee-type standby letter of credit, nationally recognized statistical rating organization, performance-based standby letter of credit, rated, securitization, servicer cash advance, standby letter of credit and traded position, to read as follows:

§ 567.1 Definitions.

* * * * *

Covered representations and warranties. The term *covered representations and warranties* means representations and warranties extended by a savings association when it transfers assets (including loan servicing assets) or assumed by a savings association when it purchases loan servicing assets, that obligate the savings association to protect another party from losses due to credit risk in the transferred assets or serviced loans.

Credit derivative. The term *credit derivative* means on- or off-balance sheet notes or contracts that allow one party to transfer the credit risk of a referenced asset, that it may own, to another party. The value of a credit derivative is dependent, at least in part, on the credit performance of the referenced asset.

* * * * *

Direct credit substitute. The term *direct credit substitute* means an arrangement in which a savings association assumes, in form or in substance, any risk of credit loss directly or indirectly associated with an asset or other financial claim owned in whole or in part by another party, that exceeds the association's *pro rata* share of the asset or claim. If the savings association has no claim on the asset, then the assumption of any risk of loss is a direct credit substitute. Direct credit substitutes include:

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

(2) Guarantees, surety arrangements, credit derivatives, and irrevocable guarantee-type instruments backing financial claims;

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

[4] For each off-balance sheet item, a conversion factor (see Table III) must be applied to determine the ''credit equivalent amount'' prior to assigning the off-balance sheet time to a risk weight category.

(4) Loans or lines of credit that provide credit enhancement for the financial obligations of an account party; and

(5) Purchased loan servicing assets if the servicer is responsible for credit losses associated with the loans being serviced (other than a servicer cash advance), or if the servicer makes or assumes covered representations and warranties with respect to such loans.

* * * * *

Financial guarantee-type standby letter of credit. The term *financial guarantee-type standby letter of credit* means any letter of credit or similar arrangement, however named or described, that represents an irrevocable obligation to the beneficiary on the part of the issuer:

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

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

* * * * *

Nationally recognized statistical rating organization. The term *nationally recognized statistical rating organization* means an entity recognized by the Division of Market Regulation of the Securities and Exchange Commission as a nationally recognized statistical rating organization for various purposes, including the uniform net capital regulations for broker-dealers.

* * * * *

Performance-based standby letter of credit. The term *performance-based standby letter of credit* means any letter of credit, or similar arrangement, however named or described, which represents an irrevocable obligation to the beneficiary on the part of the issuer to make payment on account of any default by a third party in the performance of a nonfinancial or commercial obligation. Such letters of credit include arrangements backing subcontractors' and suppliers' performance, labor and materials contracts, and construction bids.

* * * * *

Rated. The term *rated* means, with respect to an instrument or obligation, that the instrument or obligation has received a credit rating from a nationally recognized statistical rating organization. An instrument or obligation is rated investment grade if it has received a credit rating that falls within one of the four highest rating categories used by the organization. An instrument or obligation is rated in the highest investment grade if it has received a credit rating that falls within the highest rating category used by the organization.

* * * * *

Recourse. The term *recourse* means an arrangement in which a savings association retains, in form or in substance, any risk of credit loss directly or indirectly associated with a transferred asset that exceeds the *pro rata* share of the association's claim on the asset. If a savings association has no claim on a transferred asset, then the retention of any risk of loss is recourse. A recourse obligation typically arises when an institution transfers assets and retains an obligation to repurchase the assets or to absorb losses due to a default of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may exist implicitly where a savings association provides credit enhancement beyond any contractual obligation to support assets it has sold. Recourse obligations include:

(1) Covered representations and warranties on transferred assets;

(2) Retained loan servicing assets if the servicer is responsible for losses associated with the loans being serviced (other than a servicer cash advance);

(3) Retained subordinated interests or securities, or credit derivatives that absorb more than their *pro rata* share of losses from the underlying assets;

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

(5) Loan strips sold without direct recourse where the maturity of the transferred loan is shorter than the maturity of the commitment.

* * * * *

Securitization. The term *securitization* means the pooling and repackaging of loans or other credit exposures into securities that can be sold to investors. For purposes of § 567.6(b) of this part, the term *securitization* also includes transactions or programs that generally create stratified credit risk positions, whether in the form of a security or not, whose performance is dependent upon an underlying pool of loans or other credit exposures.

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

Standby letter of credit. The term *standby letter of credit* means any financial guarantee-type standby letter of credit or performance-based standby letter of credit.

* * * * *

Traded position. The term *traded position* means a recourse obligation, direct credit substitute, or asset- or mortgage-backed security that is retained, assumed, or issued in connection with an asset securitization and that is rated with a reasonable expectation that, in the near future:

(1) The position would be sold to investors relying on the rating; or

(2) A third party would, in reliance on the rating, enter into a transaction such as a purchase, loan, or repurchase agreement involving the position.

* * * * *

3. Section 567.2 is amended by revising paragraph (a)(1)(i) to read as follows:

§ 567.2 Minimum regulatory capital requirement.

(a) * * *

(1) *Risk-based capital requirement.* (i) A savings associations' minimum risk-based capital requirement shall be an amount equal to 8% of its risk-weighted assets as measured under § 567.6 of this part.

* * * * *

4. Section 567.6 is amended by:

A. Revising paragraph (a) introductory text;

B. Revising paragraph (a)(1) introductory text;

C. Revising paragraph (a)(2) introductory text;

D. Removing and reserving paragraphs (a)(2)(i)(A) and (C);

E. Revising paragraph (a)(2)(i)(B);

F. Revising paragraph (a)(2)(ii)(A);

G. Removing paragraph (a)(3); and

H. Adding paragraph (b) to read as follows:

§ 567.6 Risk-based capital credit risk-weight categories.

(a) *Risk-weighted assets.* Risk-weighted assets equal risk-weighted on-balance-sheet assets (as computed under paragraph (a)(1) of this section), plus risk-weighted off-balance-sheet activities (as computed under paragraph (a)(2) of this section), plus risk-weighted recourse obligations, direct credit substitutes and asset- and mortgage-backed securities (as computed under paragraph (b) of this section). Assets not included for purposes of calculating capital under § 567.5 are not included in calculating risk-weighted assets.

(1) *On-balance-sheet assets*. Except as provided in paragraph (b) of this section, risk-weighted on-balance-sheet assets are computed by multiplying the on-balance-sheet asset amounts times the appropriate risk weight categories. The risk weight categories for on-balance-sheet assets are:

* * * * *

(2) *Off-balance-sheet activities*. Except as provided in paragraph (b) of this section, risk-weighted off-balance-sheet items are determined by the following two-step process. First, the face amount of the off-balance-sheet item must be multiplied by the appropriate credit conversion factor listed in this paragraph (a)(2). This calculation translates the face amount of an off-balance-sheet exposure into an on-balance-sheet credit-equivalent amount. Second, the credit-equivalent amount must be assigned to the appropriate risk weight category using the criteria regarding obligors, guarantors, and collateral listed in paragraph (a)(1) of this section, *provided* that the maximum risk weight assigned to the credit-equivalent amount of an interest-rate or exchange-rate contract is 50 percent. The following are the credit conversion factors and the off-balance-sheet items to which they apply.

(i) * * *

(B) Risk participations purchased in bank acceptances.

* * * * *

(ii) * * *

(A) Transaction-related contingencies, including, among other things, performance bonds and performance-based standby letters of credit related to a particular transaction;

* * * * *

(b) *Recourse obligations, direct credit substitutes, and asset-and mortgage-backed securities*—(1) *In general*. Except as otherwise provided in this paragraph (b), to calculate the risk-weighted asset amount for a recourse obligation, direct credit substitute, or asset- or mortgage-backed security, multiply the amount of assets from which risk of credit loss is directly or indirectly retained or assumed, by the appropriate risk weight using the criteria regarding obligors, guarantors, and collateral listed in paragraph (a)(1) of this section. For purposes of this paragraph (b), the amount of assets from which risk of credit loss is directly or indirectly retained or assumed means:

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

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

(iii) For mortgage servicing assets that are recourse obligations or direct credit substitutes, the outstanding amount of unpaid principal of the loans serviced;

(iv) For covered representations and warranties, the amount of the assets subject to the representations or warranties;

(v) For loans or lines of credit that provide credit enhancement for the financial obligations of an account party, the amount of the enhanced financial obligations;

(vi) For loans strips, the amount of the loans;

(vii) For assets sold with recourse, the amount of assets from which risk of loss is directly or indirectly retained, less any applicable recourse liability account established in accordance with generally accepted accounting principles; and

(viii) Other types of recourse obligations and direct credit substitutes should be treated in accordance with the principles contained in this paragraph (b).

(2) *Ratings-based approach*—(i) *Calculation.* As an alternative to the calculation described in paragraph (b)(1) of this section, a savings association may calculate the risk-weighted asset amount for eligible recourse obligations, direct credit substitutes, or asset- or mortgage-backed securities described in paragraph (b)(2)(ii) of this section by multiplying the face amount of the position by the risk-weight associated with the applicable rating under the following chart.

Rating category	Risk weight
Highest or second highest investment grade	20%.
Third highest investment grade	50%.
Fourth highest investment grade	100%.
One grade below investment grade	200%.
More than one grade below investment grade or not rated	Risk weight the asset under paragraph (b)(1) of this section.

(ii) *Eligibility.* To be eligible for the treatment described in this paragraph (b)(2), a recourse obligation, direct credit substitute, or asset- or mortgage-backed security must meet one of the following criteria:

(A) *Traded position rated by a rating organization.* (*1*) A traded position is eligible for the risk-based capital treatment described in this paragraph (b)(2), if a nationally recognized statistical rating organization rates the position in one of its five highest grades. If two or more nationally recognized statistical rating organizations assign different ratings to a position, the savings association may use the highest rating as the rating of the position for the purposes of this paragraph (b)(2). If a rating changes, the savings association must use the new rating.

(*2*) If a recourse obligation, direct credit substitute, or asset- or mortgage-backed security or other credit risk position is not rated but is senior in all credit risk related features (including access to any collateral) to a rated, traded position, the savings association may risk weight the position under this paragraph (b)(2) using the rating of the traded position. The savings association must satisfy OTS that this treatment is appropriate.

(B) *Non-traded position rated by two rating organizations.* (*1*) A recourse obligation or direct credit substitute that is not a traded position is eligible for the treatment described in this paragraph (b)(2), if two nationally recognized statistical rating organizations rate the recourse obligation or direct credit substitute in one of their five highest grades. The organizations must apply the same criteria that they use to rate securities that are traded positions and must make the rating publicly available.

(*2*) If two or more national recognized statistical rating organizations assign different ratings to the recourse obligation or direct credit substitute, the savings association must use the second highest rating as the rating of the position for the purposes of this paragraph (b)(2). If a rating changes, the savings association must use the new rating.

(3) *Internal ratings, qualified structured transactions, and credit assessment computer programs*—(i) *Calculation.* As an alternative to the calculation described in paragraph (b)(1) of this section, a savings association may calculate the risk-weighted asset amount for eligible direct credit substitutes described in paragraph (b)(3)(ii) of this section by multiplying the face amount of the position by the risk-weight associated with the applicable rating under the following chart:

Rating category	Risk weight
Investment grade	100%.
One grade below investment grade	200%.
More than one grade below investment grade or not rated	Risk weight the asset under paragraph (b)(1) of this section.

(ii) *Eligibility.* To be eligible for the treatment described in this paragraph (b)(3), a direct credit substitute must meet one of the following criteria.

(A) *Non-traded position rated internally.* A direct credit substitute assumed or issued in connection with an asset-backed commercial paper program and that is not a traded position is eligible for the treatment described in this paragraph (b)(3), if a savings association that is the sponsor of the program rates the direct credit substitute as investment grade or one category immediately below investment grade. The savings association must use an internal risk weighting system that is satisfactory to OTS. Adequate internal risk rating systems typically:

(*1*) Are an integral part of an effective risk management system that explicitly incorporates the full range of risks arising from the institution's securitization activities.

(*2*) Link ratings to measurable outcomes, such as the probability that the position will experience loss, the expected loss on the position in the event of default, and variance of losses in the event of default on that position;

(*3*) Separately consider the risk associated with the underlying loans or borrowers, and the risk associated with the structure of the particular securitization transaction;

(*4*) Identify gradations of risk even among those assets where no loss is likely as well as other risk positions;

(*5*) Use clear, explicit criteria to classify assets into each internal rating category;

(*6*) Employ independent credit risk management or loan review personnel to assign or review the internal ratings;

(*7*) Include an internal audit procedure to periodically verify that internal risk ratings are assigned in accordance with the savings association's established criteria;

(*8*) Monitor the performance of the assigned internal ratings to determine if the system correctly identified individual ratings and, if appropriate, adjust the rating system and individual ratings; and

(*9*) Use assumptions and methodologies that are consistent with, or more conservative than, the rating assumptions and methodologies used by nationally recognized statistical rating organizations.

(B) *Non-traded positions in approved securitization or structured financing programs.* A direct credit substitute that is not a traded position is eligible for the treatment described in this paragraph (b)(3), if the position is generated through a securitization or structured financing program that is approved by OTS. OTS will not approve the use of a securitization or structured financing program unless the program meets the following minimum criteria and other appropriate prudential standards:

(*1*) A nationally recognized statistical rating organization (or other entity approved by OTS) must review the terms of the program, and state a rating for the direct credit substitutes to be issued under the program. If the program has options for different combinations of assets, standards, internal or external credit enhancements and other relevant factors, the rating organization or other approved entity may specify ranges of rating categories that will be applied based on the options that are utilized in the position.

(*2*) The savings association must demonstrate to OTS' satisfaction that the rating corresponds credibly and reliably with the ratings issued by nationally recognized statistical rating organizations for traded positions, and that the rating organization's or other entity's underlying premises are satisfied by the direct credit substitute.

(*3*) If a savings association participates in a securitization or structured financing program sponsored by another party, OTS may authorize the savings association to use this approach based on the program rating obtained by the sponsor of the program.

(C) *Non-traded position in a structured financing program rated by using qualifying credit assessment computer software.* A direct credit substitute that is not a traded position is eligible for the treatment described in this paragraph (b)(3), if the position is generated through a structured financing program and the position is rated using credit assessment computer software that has been approved by OTS. OTS will not approve the use of credit assessment computer software unless the software meets the following minimum criteria and other appropriate prudential standards:

(*1*) A nationally recognized statistical rating organization (or other entity approved by OTS) developed the computer software for determining the credit ratings of direct credit substitutes and other stratified positions; and

(*2*) The savings association must demonstrate that the ratings generated using the computer software correspond credibly and reliably with the ratings issued by nationally recognized statistical rating organizations for traded positions.

(4) *Alternative capital computation for small business obligations*—(i) *Definitions.* For the purposes of this paragraph (b)(4):

(A) *Qualified savings association* means a savings association that:

(*1*) Is well capitalized as defined in § 565.4 of this chapter without applying the capital treatment described in paragraph (b)(4)(ii) of this section; or

(*2*) Is adequately capitalized as defined in § 565.4 of this chapter without applying the capital treatment described in paragraph (b)(4)(ii) of this section and has received written permission from the OTS to apply that capital calculation.

(B) *Small business* means a business that meets the criteria for a small business concern established by the Small Business Administration in 13 CFR part 121 pursuant to 15 U.S.C. 632.

(ii) *Capital requirement.* With respect to a transfer of a small business loan or lease of personal property with recourse that is a sale under generally accepted accounting principles, a qualified savings association may elect to include only the amount of its retained recourse in its risk-weighted assets for the purposes of paragraph (b)(1) of this section. To qualify for this election, the savings association must establish and maintain a reserve under generally accepted accounting principles sufficient to meet the reasonable estimated liability of the savings association under the recourse obligation.

(iii) *Aggregate amount of recourse.* The total outstanding amount of recourse retained by a qualified savings association with respect to transfers of small business loans and leases of personal property and included in the risk-weighted assets of the savings association as described in paragraph (b)(4)(ii) of this section, may not exceed 15 percent of the association's total capital computed under § 567.5(c)(4).

(iv) *Savings association that ceases to be a qualified savings association or that exceeds aggregate limits.* If a savings association ceases to be a qualified savings association or exceeds the aggregate limit described in paragraph (b)(4)(iii) of this section, the savings association may continue to apply the capital treatment described in paragraph (b)(4)(ii) of this section to transfers of small business loans and leases of personal property that occurred when the association was a qualified savings association and did not exceed the limit.

(v) *Prompt corrective action not affected.* (A) A savings association shall compute its capital without regard to this paragraph (b)(4) of this section for purposes of prompt corrective action (12 U.S.C. 1831o), unless the savings association is adequately or well capitalized without applying the capital treatment described in this paragraph (b)(4) and would be well capitalized after applying that capital treatment.

(B) A savings association shall compute its capital requirement without regard to this paragraph (b)(4) for the purposes of applying 12 U.S.C. 1381o(g), regardless of the association's capital level.

(5) *Risk participations and syndications of direct credit substitutes.* Except as otherwise provided in this paragraph (b) and subject to the low level recourse rule, a savings association must calculate the risk-weighted asset amount for a risk participation in, or syndication of, a direct credit substitute as described below. For the purposes of this paragraph (b)(5), in a risk participation the originator of the participation remains liable to the beneficiary for the full amount of the direct credit substitute, even though another party may have acquired a participation in the obligation:

(i) Where a savings association conveys a risk participation, the savings association must risk weight the full amount the assets supported, in whole or in part, by the direct credit substitute. The savings association must assign a percentage share (*i.e.*, the percentage of the direct credit substitute that is conveyed) of these assets to the lower of: the risk-weight category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral; or the risk-weight category appropriate to the entity acquiring the participation. The remainder of the assets supported, in whole or in part, by the direct credit substitute, must be assigned to the risk-weight category appropriate to the obligor, guarantor or collateral.

(ii) If a savings association acquires a risk participation in a direct credit substitute, the savings association must multiply a percentage share (*i.e.* the percentage of the direct credit substitute that is acquired) by the full amount the assets supported, in whole or in part, by the direct credit substitute. The savings association must assign this amount to the risk-weight category appropriate to the account party obligor, guarantor or collateral.

(iii) If the savings association holds a direct credit substitute as a part of a syndication and it is obligated only for its *pro rata* share of the risk of loss on the direct credit substitute and there is no recourse to the originating entity, the savings association must assign its share of the assets supported, in whole or in part, by the direct credit substitute to the risk-weight category appropriate to the obligor, guarantor or collateral.

(6) *Limitations on risk-based capital requirements*—(i) *Low-level recourse.* If the maximum contractual liability or exposure to credit loss retained or assumed by a savings association in connection with a recourse obligation or a direct credit substitute calculated under paragraphs (b)(1) through (5) of this section is less than the effective risk-based capital requirement for the enhanced assets, the risk-based capital requirement is limited to the maximum contractual liability or exposure to loss, less any recourse liability account established in accordance with generally accepted accounting principles. This limitation does not apply to assets sold with implicit recourse.

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

(iii) *Related on-balance-sheet assets.* To the extent that an asset may be included in the calculation of risk-weighted on-balance-sheet assets under paragraph (a)(1) of this section and may also be included in the calculation of risk-weighted assets under this paragraph (b), the savings association should risk-weight the asset only under this paragraph (b), except mortgage servicing assets and similar arrangements with embedded recourse obligations or direct credit substitutes. In such cases, the mortgage servicing asset is risk weighted as an on-balance-sheet asset under paragraph (a)(1) of this section and the related recourse obligations and direct credit substitutes are risk-weighted under this paragraph (b).

(7) *Obligations of subsidiaries.* If a savings association retains a recourse obligation or assumes a direct credit substitute on the obligation of a subsidiary that is not an includable subsidiary, and the recourse obligation or direct credit substitute is an equity or debt investment in that subsidiary under generally accepted accounting principles, the face amount of the recourse obligation or direct credit substitute is deducted for capital under §§ 567.5(a)(2) and 567.9(c). All other recourse obligations and direct credit substitutes retained or assumed by a savings association on the obligations of an entity in which the savings association has an equity investment are risk-weighted in accordance with this paragraph (b).

(8) *Addition to risk-weighted assets—managed assets.* (i) A savings association must include an additional amount in the risk-weighted asset amount calculated under this paragraph (b), if:

(A) The savings association sells assets to a revolving securitization (*e.g.,* credit card receivables or home equity line securitizations) with an early amortization feature. An early amortization feature is a provision that, under specified conditions, terminates the ability of the savings association to add new receivables or debt to the securitization, and requires the savings association to use any payments received from the debtors to pay down the receivables or debts previously included in the securitization; and

(B) The savings association is the sponsor of the revolving securitization.

(ii) The additional amount is equal to the face amount of the assets that the savings association sells to the revolving securitization less the face amount of any recourse obligation or direct credit substitute that the savings association retains or assumes in connection with the sale of the asset, multiplied by a 20 percent risk weight.

5. Section 567.11 is amended by redesignating paragraph (c) as paragraph (c)(1) and adding a new paragraph (c)(2) to read as follows:

§ 567.11 Reservations of authority.

* * * * *

(c) * * *

(2) If a savings association has calculated the risk-weighted asset amount for a recourse obligation, a direct credit substitute or an asset under § 567.6(b), OTS may determine that risk-weighted asset amount does not adequately reflect the credit risk that the savings association assumed or retained in the transaction and require the institution to revise the risk-weighted asset amount to reflect the risk of, and other relevant factors associated with, the recourse obligation, direct credit substitute or asset.

Dated: February 9, 2000.

By the Office of Thrift Supervision.

Ellen Seidman,

Director.

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