Interagency Questions and Answers on the Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations

Purpose

The Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board (Board), and the Office of Thrift Supervision (OTS) (the Agencies) published a final rule on the Capital Treatment of Recourse, Direct Credit Substitutes and Residual Interests in Asset Securitizations in November of 2001.[1] The rule became effective on January 1, 2002, and has generated several questions from the industry regarding proper implementation and application. This question-and-answer document provides interpretive guidance on issues raised by the final rule. Further guidance will be provided, as necessary.

I. Scope and Definitions

A. Are spread accounts that function as credit enhancements "credit-enhancing interest-only strips" and, therefore, subject to the concentration limit?

The final rule defines "credit-enhancing interest-only strip" as "an on-balance sheet asset that, in form or in substance, (i) represents the contractual right to receive some or all of the interest due on the transferred assets; and (ii) exposes the banking organization to credit risk that exceeds its pro rata claim on the underlying assets whether through subordination provisions or other credit enhancing techniques."[2] The preamble elaborates on this definition. "In determining whether a particular interest cash flow functions as a credit-enhancing I/O strip, the Agencies will look to the economic substance of the transaction, and will reserve the right to identify other cash flows or spread-related assets as credit-enhancing I/O strips on a case-by-case basis." 66 Fed. Reg. 59614, 59622 (emphasis added).

A spread account is an on-balance sheet asset that functions as a credit enhancement and that can represent an interest in expected interest and fee cash flows derived from assets an organization has sold into a securitization. In those cases, the spread account is considered to be a "credit-enhancing interest-only strip" and is subject to the concentration limit. However, any portion of a spread account that represents an interest in cash that has already been collected and is held by the trustee is a "residual interest" subject to dollar-for-dollar capital, but not a credit enhancing interest-only strip subject to the concentration limit.

[1] 66 Fed. Reg. 59614 (November 29, 2001).
[2] 12 CFR part 3, appendix A, § 4(a)(2) (OCC). See also 12 CFR parts 208 and 225, appendix A, § II.B.1.c. (Board); 12 CFR § 325.2(g)(1) (FDIC); 12 CFR § 567.1 (OTS) (emphasis added).

For example, assume that a banking organization books a single spread account asset that is derived from two separate cash flow streams:

(1) a receivable from the securitization trust that represents cash that has already accumulated in the spread account. In accordance with the securitization documents, the cash will be returned to the banking organization at some date in the future after having been reduced by amounts used to reimburse investors for credit losses. Based on the date when the cash is expected to be paid out to the banking organization, the present value of this asset is currently estimated to be $3.

(2) a projection of future cash flows that are expected to accumulate in the spread account. In accordance with the securitization documents, the cash, to the extent collected, will also be returned to the banking organization at some date in the future after having been reduced by amounts used to reimburse investors for credit losses. Based on the date when the cash is expected to be paid out to the banking organization, the present value of this asset is currently estimated to be $2.

Both components of the spread account are considered to be residual interests under the current capital standards because both represent on-balance sheet assets subject to more than their pro rata share of losses on the underlying portfolio of sold assets. However, the $2 asset that represents the banking organization's retained interest in future cash flows exposes the organization to a greater degree of risk because the $2 asset presents additional uncertainty as to whether it will ever be collected. This additional uncertainty associated with the recognition of future subordinated excess cash flows results in the $2 asset being treated as a credit-enhancing interest-only strip, a subset of residual interests.

Under the final rule, the face amount of all of the banking organization's credit-enhancing interest-only strips is first subject to a 25% of Tier 1 capital concentration limit.[3] Any portion of this face amount that exceeds 25% of Tier 1 capital is deducted from Tier 1 capital. This limit will affect both a banking organization's risk-based and leverage capital ratios. The remaining face amount of the banking organization's credit-enhancing interest-only strips, as well as the face amount of the spread account receivable for cash already held in the trust, is subject to the dollar-for-dollar capital requirement established for residual interests, which affects only the risk-based capital ratios.

B. How are instruments that are derived from a securitization and assigned separate ratings for principal and interest (split/partially-rated instruments) treated in the final rule?

The final rule does not specifically address the treatment of split/partially-rated instruments. However, in its discussion of the ratings-based approach, the preamble to the final rule indicates that the ratings-based approach "provides a way for the agencies to use determinations of credit quality . . . to differentiate the regulatory capital treatment for loss positions representing different gradations of risk." 66 Fed. Reg. 59614, 59625. The rule contemplated treating each

[3] For savings associations, the limit is 25% of core capital.

"position" in its entirety. Thus, for those banking organizations that hold split/partially-rated instruments, the Agencies will apply to the entire instrument the risk weight that corresponds to the lowest component rating.[4] For example, a purchased subordinated security where the principal component is rated BBB, but the interest component is rated B, will be subject to the gross-up treatment accorded to direct credit substitutes rated B or lower as set forth in the final rule. Similarly, if a portion of an instrument is unrated, the entire position will be treated as if it is unrated. In addition to this regulatory capital treatment, the Agencies may also, as appropriate, adversely classify and require write-downs for other than temporary impairment on unrated and below investment grade securities, including split/partially-rated securities.

C. Do corporate bonds or other securities not related in any way to a securitization or structured finance program qualify for the ratings-based approach?

No. Only mortgage- and asset-backed securities, recourse obligations, direct credit substitutes, and residual interests (except credit-enhancing interest-only strips) retained, assumed, or issued in connection with a securitization or structured finance program, as defined in the rule, qualify for the ratings-based approach.[5] "Securitization" is defined as "the pooling and repackaging by a special purpose entity of assets or other credit exposures that can be sold to investors."[6] A "structured finance program" is defined as "a program where receivable interests and asset-backed securities issued by multiple participants are purchased by a special purpose entity that repackages those exposures into securities that can be sold to investors."[7] Corporate debt instruments, municipal bonds and other securities that are not related to a securitization or structured finance program do not meet these definitions and, thus, do not qualify for the ratings-based approach.

II. Effective Date

In a revolving securitization, would receivables sold after January 1, 2002, into a trust that existed before January 1, 2002, be immediately subject to the final rule?

No. The preamble to the final rule states that "[a]ny transactions settled on or after January 1, 2002, are subject to this final rule." It further states that "banking organizations that enter into transactions before January 1, 2002, that result in increased capital requirements under the final rule may delay the application of this rule to those transactions until December 31, 2002." 66 Fed. Reg. 59614. The sale of receivables on or after January 1, 2002, into a trust that existed as of December 31, 2001, would not trigger the immediate imposition of the capital requirements contained in the final rule, provided the sale was required under the trust documents in effect on

[4] The Agencies also remind banking organizations that the Agencies may "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 that an instrument poses to banking organizations." 66 Fed. Reg. 59614, 59625.
[5] See 12 CFR part 3, appendix A, § 4(d)(1); 12 CFR parts 208 and 225, appendix A, § III.B.3.c.i (Board); 12 CFR part 325, appendix A, § II.B.5(d)(1) (FDIC); 12 CFR § 567.6(b)(3) (OTS).
[6] 12 CFR part 3, appendix A, § 4(a)(14) (OCC). See also 12 CFR parts 208 and 225, appendix A, § III.B.3.a.xiii (Board); 12 CFR part 325, appendix A, § II.B.5(a)(14) (FDIC); 12 CFR § 567.1 (OTS).
[7] 12 CFR part 3, appendix A, § 4(a)(15) (OCC); 12 CFR parts 208 and 225, appendix A, § III.B.3.a.xiv. (Board); 12 CFR part 325, appendix A, § II.B.5(a)(15) (FDIC); 12 CFR § 567.1 (OTS).

December 31, 2001. Instead, the capital requirements contained in the final rule would apply beginning on December 31, 2002. Moreover, the establishment of any new trust on or after January 1, 2002, would be considered a new "transaction" and would subject assets sold into that trust, and any positions resulting from the securitization of those assets, to the final rule immediately.

III. Clean-up Calls

A. Concerning the repurchase of assets pursuant to a clean-up call, the preamble to the final rule states that a "banking organization should repurchase the loans at the lower of their estimated fair value or their par value plus accrued interest." 66 Fed. Reg. 59614, 59624. May the banking organization determine an aggregate fair value for all repurchased assets or should each repurchased loan be individually evaluated?

Banking organizations that repurchase assets as a result of the exercise of a clean-up call may do so based on the aggregate fair value of all repurchased assets. The Agencies did not intend for each individual loan remaining in the pool at the time a clean-up call is exercised to be individually evaluated to determine its fair value. Rather, the overall repurchase price should reflect the aggregate fair value of the assets being repurchased so that the banking organization is not overpaying for the assets and, in so doing, providing credit support to the trust investors. Supervisors will review the terms and conditions relating to the repurchase arrangements in clean-up calls to ensure that transactions are done at the lower of fair value or par value plus accrued interest. Banking organizations should be able to support their fair value estimates. Should the Agencies conclude that a banking organization has repurchased assets at a price that exceeds the lower of these two amounts, the clean-up call provisions in an organization's future securitizations may be treated as recourse obligations or direct credit substitutes.

B. The final rule states that "clean-up calls that are 10% or less of the original pool balance and that are exercisable at the option of the [banking organization]" are not recourse or direct credit substitutes. May this treatment also apply to clean-up calls written with reference to less than 10% of the outstanding principal amount of securities?

Yes. The Agencies will not require recourse or direct credit substitute treatment for clean-up calls written with reference to 10% of the outstanding principal amount of the securities. The purpose of treating large clean-up calls as recourse or direct credit substitutes is to ensure that banking organizations are not able to provide credit support to the trust investors by repaying their investment when the credit quality of the pool is deteriorating without holding capital against the exposure.[8] A clean-up call based on 10% of outstanding securities would not defeat the purpose of the rule and, oftentimes, may be a more conservative benchmark than 10% of the pool balance.

[8] See 66 Fed. Reg. 59614, 59623-4 (preamble discussion of clean-up calls).

C. Does the mere existence of a clean-up call in a securitization trigger treatment as a recourse obligation or direct credit substitute or must the clean-up call be exercised in order to trigger this treatment?

The final rule includes clean-up calls as an example of both a "recourse" arrangement[9] and a "direct credit substitute."[10] The rule focuses on the arrangement itself, and not the exercise of the call. Thus, the existence, not the exercise, of a clean-up call that does not meet the requirements laid out in the final rule will trigger treatment as a recourse obligation or a direct credit substitute. A clean-up call can function as a credit enhancement because its existence provides the opportunity for a banking organization (as servicer or as an affiliate of the servicer) to provide credit support to investors by taking an action that is within the contractual terms of the securitization documents.

IV. Other Issues

A. Does the final rule change the risk weight/conversion factor for performance standby letters of credit?

No. "Performance standby letters of credit," as defined in the Agencies' risk-based capital standards,[11] generally do not meet the definition of a direct credit substitute. Therefore, they are not covered under the final rule and will still be converted at 50% and generally risk weighted at 100%.[12]

B. The final rule states that for an internal credit risk rating system for an asset-backed commercial paper program to be adequate, "an internal audit procedure should periodically verify that internal risk ratings are assigned in accordance with the banking organization's established criteria."[13] Does the internal audit procedure have to be performed by the internal audit department or can it be performed by another independent entity within the organization?

The final rule does not require the internal audit of the internal credit risk rating system to be performed by the internal audit department. Any group within the organization that is qualified to audit the system and independent of both the group that makes the decision to extend credit to the asset-backed commercial paper program and the groups that develop and maintain the internal credit risk rating system may perform the internal audit of the system.

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[9] 12 CFR part 3, appendix A, § 4(a)(11)(vii) (OCC); 12 CFR parts 208 and 225, appendix A, § III.B.3.a.x.7 (Board); 12 CFR part 325, appendix A, § II.B.5(a)(11)(vii) (FDIC); 12 CFR § 567.1 (OTS).
[10] 12 CFR part 3, appendix A, § 4(a)(4)(vii) (OCC); 12 CFR parts 208 and 225, appendix A, § III.B.3.a.iii.7 (Board); 12 CFR part 325, appendix A, § II.B.5(a)(4)(vii) (FDIC); 12 CFR § 567.1 (OTS).
[11] See 12 CFR part 3, appendix A § 3(b)(2) (OCC); 12 CFR parts 208 and 225, appendix A, § III.D.2 (FRB); 12 CFR part 325, appendix A, § II.D.2 (FDIC); 12 CFR § 567.1 (OTS).
[12] 12 CFR part 3, appendix A, section 3(b)(2)(i) (OCC). See also 12 CFR Parts 208 and 225, appendix A, § III.D.2. (Board); 12 CFR part 325, Appendix A, § II.D.2 (FDIC); 12 CFR § 567.6(a)(2)(ii) (OTS).
[13] 12 CFR part 3, appendix A, § 4(g)(1)(vii) (OCC); 12 CFR parts 208 and 225, appendix A, § III.B.3.f.i.7 (Board); 12 CFR part 325, Appendix A, § II.B.5(g)(1)(vii) (FDIC); 12 CFR § 567.6(b)(4)(ii)(A)(7) (OTS).

C. How is the capital treatment described in the Synthetic Collateralized Loan Obligations guidance published by the OCC (OCC 99-43) and the Board (SR 99-32) in November 1999 affected by the final rule?

The preamble to the final rule addresses the modification of the treatment of credit derivative transactions outlined in the November 1999 guidance. "With the issuance of this final rule, the agencies reaffirm the validity of the structural and risk-management requirements of the December [sic] 1999 guidance on synthetic securitizations issued by the Board and the OCC, while modifying the risk-based capital treatment detailed therein with the treatment presented in this final rule." 66 Fed. Reg. 56914, 59622. The following detailed information will clarify the risk-based capital treatment appropriate to the credit derivative transactions presented in the November 1999 guidance.

The joint OCC and Board guidance on synthetic collateralized loan obligations discussed the risk-based capital treatment of three specific types of synthetic securitization transactions, subject to the sponsoring banking organization's compliance with minimum risk management requirements. The objective of these capital interpretations was to recognize the effective transference of the economic risk of loss in these synthetic securitization transactions. As discussed more fully below, the risk-based capital treatment of the first two structures described in the November 1999 guidance remains largely unchanged. The qualification requirements for the second structure (Bistro-type transactions) have been modified to eliminate the restriction on the size of the retained first loss position. The final rule has the greatest effect on the risk-based capital treatment of the third structure. As indicated in the preamble to the final rule, the risk management requirements contained in the joint OCC and Board guidance are still in force.

In the first structure the sponsoring banking organization, through a synthetic collateralized loan obligation (CLO), hedges the entire notional amount of a reference asset portfolio. The credit protection is obtained through the issuance of credit-linked notes (CLNs), the proceeds of which fully collateralize a portfolio of the banking organization's loans. The zero risk-weight on the cash-collateralized loans is not affected by the final rule.

In structure 2 (Bistro-type) transactions, the sponsoring banking organization hedges a portion of the reference portfolio and retains a high quality senior risk position that absorbs only those credit losses in excess of the junior loss positions. There is no change in the capital treatment for this type of transaction under the final rule: dollar-for-dollar capital on the retained first loss piece[14] and a 20 percent risk weight on the retained senior piece if it is senior to AAA-rated credit-linked notes (CLNs). The final rule expressly permits "inferred" ratings.[15] To obtain that capital treatment, it is no longer necessary to limit the retained first loss piece to "a small cash

[14] 12 CFR part 3, appendix A, § 4(f)(3) (OCC); 12 CFR parts 208 and 225, Appendix A, § III.B.3.e (Board); 12 CFR part 325, appendix A, § II.B.5(f)(3) (FDIC). If the banking organization can obtain a rating of BB or better on the first loss position, and the first loss position is not a credit-enhancing interest-only strip (as defined in the final rule), then the banking organization may be able to apply a more favorable risk weight to the first loss position. See 12 CFR part 3, appendix A, § 4(d); 12 CFR parts 208 and 225, Appendix A, § III.B.3.c (Board); 12 CFR part 325, appendix A, § II.B.5(d) (FDIC).

[15] 12 CFR part 3, appendix A, § 4(e) (OCC); 12 CFR parts 208 and 225, Appendix A, § III.B.3.d (Board); 12 CFR part 325, appendix A, § II.B.5(e) (FDIC).

reserve, sufficient to cover expected losses" as specified in the guidance. A banking organization entering into a structure 2-type transaction still must satisfy the risk management conditions contained in the annex of the guidance in order to receive the risk-based capital treatment described above.

In a structure 3 transaction, the sponsoring banking organization retains a subordinated position that absorbs first losses in a reference portfolio. The joint OCC and Board guidance identified three distinguishing features of a structure 3-type transaction: (1) the sponsoring banking organization retains a first loss position greater than expected loss, (2) an intermediary OECD bank establishes a special purpose entity (SPE) to issue the AAA-rated CLNs, and (3) the sponsoring banking organization purchased protection on both the second loss and the senior positions from the intermediary bank. Under the joint guidance, the capital treatment was the larger of two alternative approaches: (1) dollar-for-dollar capital on the retained first loss piece or (2) application of the risk weight of the underlying exposures to the face amount of the first loss piece, plus zero percent risk weight on the collateralized mezzanine position, and plus 20 percent risk weight on the retained senior position protected by a credit derivative from the intermediary bank. The final rule changes this capital treatment.

Under the final rule, a sponsoring banking organization entering into a structure 3-type transaction would hold dollar-for-dollar capital on the retained first loss piece.[16] The senior loss position would receive a 20 percent risk weight when protected by a credit derivative from an OECD bank or from certain qualifying securities firms.[17] The mezzanine, second-loss position that is collateralized by U.S. Treasury securities would continue to receive a zero percent risk weight.

This interpretation, particularly the lifting of the restriction on the size of the retained first loss piece on structure 2 transactions, removes the main structural distinction between structure 2 and structure 3 transactions. (The other structural difference, the issuance of the CLNs by an SPE established by an intermediary bank, does not affect the credit protection obtained by the sponsoring banking organization.) In both structures, the second loss position is collateralized by U.S. Treasury securities. Thus, a sponsoring banking organization's credit risk exposure for the first and second loss positions is virtually identical whether it employs structure 2, and forms an SPE directly to issue the CLNs, or structure 3, and purchases credit protection from an intermediary that forms the SPE to issue the CLNs. If the sponsoring banking organization satisfies all of the risk management conditions contained in the annex of the joint agency guidance, a structure 3 transaction may be classified as a structure 2 transaction and qualify for the risk-based capital treatment for such transactions. In other words, the sponsoring banking organization no longer is required to purchase protection on the senior loss position in order to assign a 20 percent risk weight to that position. Rather, it can assign a 20 percent risk weight based on the inferred rating of the subordinate credit linked notes. However, if the sponsoring banking organization does not meet the risk management conditions, it must purchase credit

[16] See note 13, supra.
[17] See 67 Fed. Reg. 16971, 16976 (referencing OCC regulatory text section 3(a)(2)(xiii) of 12 CFR part 3, appendix A that describes those securities firms that would qualify for a 20% risk weight under the final rule revising the risk weights for certain claims on securities firms).

protection from an OECD bank or securities firm that qualifies for a 20 percent risk weight, before assigning a 20 percent risk weight to the retained senior position.[18]

Additionally, because the zero percent risk weight on the second loss position is due to the U.S. Treasury securities collateral, not the type of intermediary that establishes the SPV, the sponsoring banking organization could use a non-depository institution as an intermediary. However, because synthetic transactions expose banking organizations to risk other than credit risk, the intermediary should be of high quality, e.g. at least investment grade.

The Agencies plan to revise the Risk Based Capital Treatment of Synthetic Collateralized Loan Obligations guidance to reflect the changes described above.

[18] If the sponsoring bank decides to use an intermediary that is not an OECD bank or a securities firm that qualifies for a 20% risk weight, the sponsoring bank must assign a 100% risk weight to the senior position.