Federal Register

Thursday,
November 29, 2001

Part II

Department of the Treasury

Office of the Comptroller of the Currency

Office of Thrift Supervision

12 CFR Parts 3 and 567

Federal Reserve System

12 CFR Parts 208 and 225

Federal Deposit Insurance Corporation

12 CFR Part 325

Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Capital Treatment of Recourse, Direct Credit Substitutes and Residual Interests in Asset Securitizations; Final Rules

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Part 3

[Docket No. 01–24]

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. 2001–68]

RIN 1550–AB11

Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Capital Treatment of Recourse, Direct Credit Substitutes and Residual Interests in Asset Securitizations

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: Final rule.

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 changing their regulatory capital standards to address the treatment of recourse obligations, residual interests and direct credit substitutes that expose banks, bank holding companies, and thrifts (collectively, banking organizations) primarily to credit risk. The final rule treats recourse obligations and direct credit substitutes more consistently than the agencies' current risk-based capital standards and adds new standards for the treatment of residual interests, including a concentration limit for credit-enhancing interest-only strips. In addition, the agencies 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 for certain positions in asset securitizations. The final rule does not include the proposed requirement that the sponsor of a revolving credit securitization that involves an early amortization feature hold capital against the amount of assets under management.

This rule is intended to result in a more consistent treatment for similar transactions among the agencies, more consistent regulatory capital treatment for certain transactions involving similar risk, and capital requirements that more closely reflect a banking organization's relative exposure to credit risk.

DATES: This rule is effective January 1, 2002. Any transactions settled on or after January 1, 2002, are subject to this final rule. Banking organizations that enter into transactions before January 1, 2002, may elect early adoption, as of November 29, 2001, of any provision of the final rule that results in a reduced capital requirement. Conversely, 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.

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I. Introduction

The agencies are amending their regulatory capital standards to change

the treatment of certain recourse obligations, direct credit substitutes, residual interests and other positions in securitized transactions that expose banking organizations to credit risk. This final rule amends the agencies' regulatory capital standards to align more closely the risk-based capital treatment of recourse obligations and direct credit substitutes, to vary the capital requirements for positions in securitized transactions (and certain other credit exposures) according to their relative risk, and to require capital commensurate with the risks associated with residual interests.

A. Asset Securitization

This final rule 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 low-level recourse transactions, and to treat first-loss (but not second-loss) direct credit substitutes like recourse. 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 from nationally recognized statistical rating organizations (rating agencies) 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, Pub. L. 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. 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, November 5, 1997 (1997 Proposal). In the 1997 Proposal, the agencies proposed to use credit ratings from rating agencies to determine the capital requirements for recourse obligations, direct credit substitutes, and senior asset-backed securities in asset securitizations. Additionally, the 1997 Proposal requested comment on a series of options and alternatives to supplement or replace the proposed ratings-based approach.

On March 8, 2000, the agencies published a third notice of proposed rulemaking on recourse and direct credit substitutes. 65 FR 12320, March 8, 2000 (2000 Recourse Proposal). The 2000 Recourse Proposal built on the ratings-based approach and eliminated several options from the 1997 Proposal, including the modified gross-up approach, the ratings benchmark approach, and the historical losses approach. The 2000 Recourse Proposal also permitted 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, or qualifying software to determine the capital requirement for certain unrated direct credit substitutes. Finally, the 2000 Recourse Proposal required a sponsor of a revolving credit securitization that contained an early amortization feature to hold capital against the amount of assets under management in that securitization.

In the international arena, the Basel Committee on Banking Supervision (of which the OCC, the Board, and the FDIC are members) issued a consultative paper entitled, ''A New Capital Adequacy Framework'' in January 2001,[2] on 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 standards established by this final rule are consistent in many respects with the Basel Consultative Paper. In particular, the use of external credit ratings issued by rating agencies as a basis for determining the credit quality and the resulting capital treatment of securitizations is consistent with the approach outlined by the Basel Committee. While the agencies believe that it is essential to address securitizations by rule at this time, they intend to consider additional changes to this rule when revisions to the Basel Accord are finalized.

B. Residual Interests

In response to the increased use of securitizations by instititutions, the agencies published Interagency Guidance on Asset Securitization Activities [4] in December 1999 (Securitization Guidance), which addresses the supervisory concerns with the risk management and oversight of securitization programs.[5] The Securitization Guidance highlighted the most significant risks associated with asset securitization, emphasized the agencies' concerns with certain residual interests generated from the securitization and sale of assets, and set forth fundamental risk management practices for banking organizations that engage in securitization activities. In addition, the Securitization Guidance stressed the need for management to implement policies and procedures that include limits on the amount of residual interests that may be carried as a percentage of capital. Furthermore, the Guidance stated that, given the risks presented by these activities, the agencies would actively consider the establishment of regulatory restrictions that would limit or eliminate the amount of certain residual interests that could be recognized in determining the adequacy of regulatory capital.

In September 2000, the agencies published a notice of proposed rulemaking on residual interests in asset securitizations and other transfers of financial assets. 65 FR 57993, September 27, 2000 (Residuals Proposal). The proposal more directly addressed the agencies' concerns with residual interests, which were highlighted in the Securitization Guidance. The Residuals Proposal defined residual interests and proposed a deduction from Tier 1 capital [6] for the amount of residual interests held by a banking organization that exceed 25% of Tier 1 capital (concentration limit). The agencies further proposed that risk-based capital be held dollar-for-dollar against the remaining residuals (dollar-for-dollar capital charge) even if the resulting capital charge exceeded the full risk-based capital charge (*e.g.,* 8%) typically held against the transferred assets that are supported by the residual. The Residuals Proposal also permitted banking organizations to calculate the amount of a residual ''net-of-associated deferred tax liability'' in determining the appropriate amount of

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

[2] The January 2001 Basel Consultative Paper amends and refines a Consultative Paper issued in June 1999.

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

[4] *See* OCC Bulletin 99–46 (December 14, 1999) (OCC); FDIC Financial Institution Letter 109–99 (December 13, 1999) (FDIC); SR Letter 99–37(SUP) (December 13, 1999) (Board); and CEO LTR 99–119 (December 14, 1999) (OTS).

[5] The agencies previously considered, but declined to adopt, capital rules imposing concentration limits on certain residual assets, *i.e.,* interest-only strips. *See* 63 FR 42668 (August 10, 1998). This 1998 rulemaking is discussed more fully at section II.C.3. of this preamble.

[6] The OTS also uses the term ''core capital'' to describe Tier 1 capital.

capital required. In no event would the amount of capital have exceeded the residual interest balance.

C. The Combined Final Rule

The agencies collectively received 32 comments on the 2000 Recourse Proposal and 34 comments on the Residuals Proposal. Comments were received from banks and thrifts, law and accounting firms, trade associations, and government-sponsored enterprises. Commenters generally favored the ratings-based approach proposed in the 2000 Recourse Proposal, but were concerned about the increased capital requirements outlined for residuals in the Residuals Proposal.

The two proposals overlap in scope in that both address leveraged credit risk. As many commenters noted, for certain positions the Residuals Proposal required capital treatment that differed from that required under the 2000 Recourse Proposal. Recognizing the overlap and interaction between the two proposals, the agencies have developed a single final rule that combines aspects of the Residuals Proposal and the 2000 Recourse Proposal.

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 [7] provides an efficient mechanism for banking organizations to buy and sell loan assets or credit exposures and thereby to increase the organization's liquidity.

Securitizations typically carve up the risk of credit losses from the underlying assets and distribute it to different parties. The ''first dollar,'' or most subordinate, loss position is first to absorb credit losses; the most ''senior'' investor position is last to absorb losses; 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 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 and may assume the credit risk on the underlying mortgages. However, many of today's asset securitization programs involve assets that are not Federally supported in any way. Sellers of these privately securitized assets therefore often provide other forms of credit enhancement—that is, they take first or second dollar loss positions—to reduce investors' credit risk.

A seller may provide this credit enhancement itself through recourse arrangements. The agencies use the term ''recourse'' to refer to the credit risk 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 also associated with asset securitization programs. 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 excess spread accounts, overcollateralization, retained subordinated interests, or other similar on-balance sheet assets. When these or other on-balance sheet internal enhancements are provided, the enhancements are ''residual interests'' for regulatory capital purposes. Such residual interests are a form of recourse.

A seller may also arrange for a third party to provide credit enhancement [8] 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 final rule, all forms of third-party enhancements, *i.e.,* all arrangements in which a banking organization assumes credit risk from third-party assets or other claims that it has not transferred, are referred to as ''direct credit substitutes.'' [9] The economic substance of a banking organization's credit risk from providing a direct credit substitute can be identical to its credit risk from retaining recourse on assets it has transferred.

Many asset securitizations use a combination of recourse and third-party enhancements to protect investors from credit risk. When third-party enhancements are not provided, the selling banking organization ordinarily retains virtually all of the credit risk on the assets transferred.

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. 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 capital treatment required by the final rule provides one important way of addressing the credit risk presented by securitization activities. However, 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 synthetic securitizations 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 any retained residual portfolio. 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 advanced and formal approaches to manage the risks.

The Securitization Guidance addresses the fundamental risk management practices that should be in

[7] For purposes of this discussion, references to ''securitization'' also include structured finance transactions or programs and synthetic transactions 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. Synthetic transactions bundle credit risks associated with on-balance sheet assets and off-balance sheet items and resell them into the market. For examples of synthetic securitization structures, *see* Banking Bulletin 99–43, November 15, 1999 (OCC); SR Letter 99–32, Capital Treatment for Synthetic CLOs, November 17, 1999 (Board).

[8] As used in this final rule, the terms ''credit enhancement'' and ''enhancement'' refer to both recourse arrangements, including residual interests, and direct credit substitutes.

[9] For purposes of this rule, purchased credit-enhancing interest-only strips are also ''residual interests.''

place at banking organizations that engage in securitization activities. The Guidance stresses the need for management to implement policies and procedures that include limits on the amount of residual interests that may be carried as a percentage of capital. Moreover, the Securitization Guidance sets forth the supervisory expectation that the value of a residual interest in a securitization must be supported by objectively verifiable documentation of the asset's fair market value using reasonable, conservative valuation assumptions. Residual interests that do not meet this expectation, or that fail to meet the supervisory standards set forth in the Securitization Guidance, should be classified as ''loss'' and disallowed as assets of the banking organization for regulatory capital purposes.

Moreover, the agencies indicated in the Securitization Guidance that banking organizations found to be lacking effective risk management programs or engaging in practices that present safety and soundness concerns will be subject to more frequent supervisory review, limitations on residual interest holdings, more stringent capital requirements, or other supervisory response. Thus, 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 and may result in a downgrading of a banking organization's CAMELS or BOPEC [10] rating.

C. Current Risk-Based Capital Treatment of Recourse, Residual Interests and Direct Credit Substitutes

Currently, the agencies' risk-based capital standards apply different treatments to recourse obligations, including residual interests, and direct credit substitutes. As a result, capital requirements applicable to credit enhancements do not consistently reflect credit risk, even though the risk characteristics are similar. The current rules of the OCC, Board, and FDIC (the banking agencies) are also not entirely consistent with those of the OTS. One objective of the final rule is to remove or reduce these inconsistencies.

1. Recourse and Retained Residual Interests

The agencies' risk-based capital guidelines prescribe a single treatment for assets transferred with recourse (including retained residual interests), regardless of whether the transaction is reported as a sale of assets or as a financing in a bank's Consolidated Report of Condition and Income (Call Report), a bank holding company's FR Y–9 reports, or a thrift's Thrift Financial Report. 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 with recourse (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.[11] If the seller's balance sheet includes as an asset (other than a servicing asset) any interest that acts as a credit enhancement to the assets sold, that interest is not risk-weighted a second time as an on-balance sheet item. Thus, regardless of the method used to account for the transfer, risk-based capital is held against the full, risk-weighted amount of the assets transferred with recourse, unless the transaction is subject to the low-level recourse rule.[12]

The low-level recourse rule limits the maximum risk-based capital requirement to the lesser of the banking organization's maximum contractual exposure or the full capital charge against the outstanding amount of assets transferred with recourse. When the low-level recourse rule applies, a banking organization generally holds capital on a dollar-for-dollar basis against the amount of its maximum contractual exposure. In the absence of any other recourse provisions, the on-balance sheet amount of a residual interest represents the maximum contractual exposure. For example, assume that a banking organization securitizes $100 million of credit card loans and records a residual interest on the balance sheet of $5 million that serves as a credit enhancement for the assets transferred. Before the low-level recourse rule was issued, the banking organization was required to hold $8 million of risk-based capital against the $100 million in loans sold, as though the loans had not been sold. Under the low-level recourse rule, the banking organization is required to hold $5 million in capital, that is, ''dollar-for-dollar'' capital up to the banking organization's maximum contractual exposure. However, if the banking organization has recorded a residual interest of $10 million (rather than $5 million), the low-level recourse rule would not have applied. The banking organization would have been required to hold the full capital charge, *i.e.,* $8 million in this example, even though its maximum contractual exposure was $10 million.

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 banking organization's balance sheet and the banking organization need not hold leverage capital against these assets. However, because certain recourse obligations (*e.g.,* retained residual interests) are recorded as an asset on the seller's balance sheet, leverage capital must be held against those obligations.

2. Direct Credit Substitutes

Direct credit substitutes are treated differently from recourse obligations under the existing risk-based capital standards. Currently, 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 face amount of the direct credit substitute is converted into an on-balance sheet credit equivalent amount. As a result, 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

[10] CAMELS is the acronym for the supervisory rating assigned to banks and thrifts. It measures Capital, Asset quality, Management, Earnings, Liquidity and Sensitivity to market risk. BOPEC is the acronym for the supervisory rating assigned to bank holding companies. It measures performance of Banking subsidiaries, Other subsidiaries, the Parent holding company, Earnings and Capital.

[11] Consistent with statutory requirements, the agencies' current rules also provide for special treatment of sales of small business 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(a)(3) (OTS). *See also* discussion in section III.B.11 of this preamble.

[12] 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.

even though the economic risk of loss is similar. For example, if a direct credit substitute covers losses up to the first 20% of $100 of enhanced assets, then the on-balance sheet credit equivalent amount equals $20, and risk-based capital is held against only the $20 amount. In contrast, required capital for a first-loss 20% recourse arrangement on $100 of transferred assets is higher because capital is held against the entire $100 of the assets enhanced.

Currently, under the banking agencies' risk-based capital guidelines, purchased subordinated interests receive the same capital treatment as off-balance sheet direct credit substitutes; that is, only the dollar 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, even though the economic and credit risks are similar. As a result, the banking organization must hold capital against the carrying amount of the retained subordinated interest as well as the outstanding dollar 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 Capital Treatment

The agencies' current leverage and 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 similar credit risks. Banking organizations are taking advantage of this anomaly, for example, by taking first-loss positions through financial standby letters of credit, *i.e.,* direct credit substitutes, in asset-backed commercial paper conduits that lend directly to corporate customers. These direct credit substitutes are accorded a significantly lower capital requirement than if a banking organization were to retain a subordinated position in a securitization comprised of loans that had originally been carried on its balance sheet, *i.e.* a recourse obligation, notwithstanding that the credit risks of both positions are virtually the same. 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, residual interest, direct credit substitute, and associated terms.

Residual interests, including retained or purchased credit-enhancing interest-only strips (credit-enhancing I/Os), raise further supervisory concerns. Fair value is the basis for the initial measurement and, in most cases, the ongoing measurement of residual interests on banking organizations' balance sheets. In addition, declines in fair value trigger determinations as to whether other than temporary impairments of residual interests should be recognized. Banking organizations' fair value estimates for these instruments, however, are often based on unwarranted assumptions about expected future cash flows. No active market exists for many residual interests, including credit-enhancing I/Os. As a result, there is no marketplace from which an arm's length market price can readily be obtained to support the residual interest valuation. Recent examinations have highlighted the inherent uncertainty and volatility regarding the initial and ongoing valuation of credit-enhancing I/Os and other residual interests. A banking organization that securitizes assets may overvalue its residual interests, including its credit-enhancing I/Os, and thereby inappropriately generate "paper profits" (or mask actual losses) through incorrect cash flow modeling, flawed loss assumptions, inaccurate prepayment estimates, and inappropriate discount rates. This often leads to an inflation of capital, making the banking organization appear more financially sound than it is. Embedded within residual interests, including credit-enhancing I/Os, is a significant level of credit and prepayment risk that make their valuation extremely sensitive to changes in underlying assumptions. Market events can affect the discount rate, prepayment speed or performance of the underlying assets in a securitization transaction and can swiftly and dramatically alter their value. A banking organization that holds an excessive concentration of residual interests in relation to capital presents significant safety and soundness concerns.

Existing regulatory capital rules do not adequately reflect the risks associated with residual interests. Often, banking organizations that securitize and sell higher risk assets are required to retain a large residual interest (often greater than the full capital charge of 8 percent on 100 percent risk-weighted assets) to ensure that the more senior positions in the securitization or other asset sale can receive the desired investment ratings. The booking of a residual interest using gain-on-sale accounting can increase the selling banking organization's capital and thereby allow the banking organization to leverage the capital created from the securitization. This creation of capital is most commonly associated with credit-enhancing I/Os and other spread-related assets. Write-downs of the recorded value of the residual interest due to changes in assumptions concerning loss, prepayment or discount rates can subsequently result in losses. Any losses in excess of the full capital charge (8 percent in the example above) will negatively affect the capital adequacy of the banking organization and, thereby, its safety and soundness.

Moreover, the current capital rules also do not subject either purchased or retained credit-enhancing I/Os to a concentration limit. In 1998, the agencies amended their capital rules to impose strict limits on the amount of nonmortgage servicing assets that may be included in Tier 1 capital.[13] These strict limitations were imposed due to the lack of depth and maturity of the marketplace for such assets, and related concerns about their valuation, liquidity, and volatility.

The agencies, however, considered but declined to adopt similar concentration limits for I/O strips in that 1998 rulemaking, notwithstanding that certain I/O strips possessed cash flow characteristics similar to servicing assets and presented similar valuation, liquidity, and volatility concerns. The agencies chose not to impose such a limitation in recognition of the "prudential effects of banking organizations relying on their own risk assessment and valuation tools, particularly their interest rate risk, market risk, and other analytical models." [14] The agencies expressly indicated that they would continue to review banking organizations' valuation of I/O strips and the concentrations of these assets relative to capital.

[13] See 63 FR 42688 August 10, 1998.

[14] Id. at 42672.

Moreover, the agencies noted that they "may, on a case-by-case basis, require banking organizations that the agencies determine have high concentrations of these assets relative to their capital, or are otherwise at risk from these assets, to hold additional capital commensurate with their risk exposures." [15]

When the servicing assets final rule was issued in 1998, most I/O strips used as credit enhancements did not exceed the full-capital charge on the transferred assets. However, the securitization of higher risk loans has resulted in residual interests, such as credit-enhancing I/O strips, that exceed the full-capital charge. In addition, certain banking organizations engaged in such securitization transactions have significant concentrations in highly volatile credit-enhancing I/Os as a percentage of capital.

III. Description of the Final Rule: Treatment of Recourse, Residual Interests and Direct Credit Substitutes

This final rule amends the agencies' regulatory capital standards as follows:

- It defines the terms "recourse," "residual interest" and related terms and revises the definition of "direct credit substitute";
- It provides more consistent risk-based capital treatment for recourse obligations and direct credit substitutes;
- It varies the capital requirements for positions in securitization transactions according to their relative risk exposure, using credit ratings from rating agencies to measure the level of risk;
- It permits the limited use of a banking organization's qualifying internal risk rating system to determine the capital requirement for certain unrated direct credit substitutes;
- It permits the limited use of a rating agency'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 recourse exposures (but not residual interests);
- It requires a banking organization to deduct credit-enhancing interest-only strips, whether retained or purchased, that are in excess of 25% of Tier 1 capital from Tier 1 capital and from assets (concentration limit);
- It requires a banking organization to maintain risk-based capital in an amount equal to the face amount of a residual interest that does not qualify for the ratings-based approach (including credit-enhancing interest-only strips that have not been deducted from Tier 1 capital) (dollar-for-dollar capital); and
- It permits each agency to modify a stated risk-weight, credit conversion factor or credit equivalent amount, if warranted, on a case-by-case basis.

The agencies intend to apply this final rule to the substance, rather than the form, of a securitization transaction. Regulatory capital will be assessed based on the risks inherent in a position within a securitization, regardless of its characterization.

A. The General Approach Taken in the Final Rule

1. Combined Final Rule

As noted above, this final rule harmonizes the proposed capital treatment for residuals with the broader capital treatment for recourse and direct credit substitutes. It also permits the use of ratings to match the risk-based capital requirement more closely to the relative risk of loss in asset securitizations (see discussion below at section III.C.). Highly rated investment-grade positions in securitizations receive a favorable (less than 100 percent) risk-weight. Below-investment grade or unrated positions in securitizations would receive a less favorable risk-weight (generally greater than 100 percent risk-weight). A residual interest retained by a banking organization in an asset securitization (other than a credit-enhancing I/O strip) would be subject to this capital framework. Therefore, if the external rating provided to such a residual interest is investment grade or no more than one category below investment grade, the final rule affords that residual interest more favorable capital treatment than the dollar-for-dollar capital requirement otherwise required for residuals (see discussion below in section III.C.).

2. Managed Assets Capital Charge

The 2000 Recourse Proposal proposed to assess a risk-based capital charge on sponsors of revolving credit securitizations that contain an early amortization feature (managed assets capital charge). All commenters that addressed the managed assets issue opposed the adoption of such a capital charge. Commenters noted that the risks the managed assets capital charge is meant to address (*e.g.*, liquidity risk and credit risk) are not unique to securitizations with early amortization features. Several commenters observed that liquidity risk exists in varying degrees in every banking organization, and implicit recourse arises any time that a banking organization securitizes assets. Commenters also noted that a banking organization faces the credit risk associated with future receivables resulting from revolving loan commitments even if the banking organization is not involved in securitization.

For these reasons, the agencies have agreed at this time not to assess risk-based capital against securitized off-balance sheet assets in revolving securitizations incorporating early amortization provisions. The agencies strongly believe, however, that the risks associated with securitization, including those posed by an early amortization feature, are not fully captured in current regulatory capital rules and need to be addressed. Therefore, the agencies plan to make a more comprehensive assessment of the risks to a selling banking organization posed by the securitization process, including the risks arising from early-amortization features, implicit recourse arrangements and non-credit risks. The agencies have not, as yet, determined whether they will issue a proposed capital rule or supervisory guidance on this matter.

3. Capital Charge for Residual Interests

The final rule imposes a "dollar-for-dollar" capital charge on residual interests and a concentration limit on a subset of residual interests—credit-enhancing I/O strips.[16] Under the combined approach, credit-enhancing I/O strips are limited to 25% of Tier 1 capital. Everything above that amount will be deducted from Tier 1 capital. Generally, all other residual interests that do not qualify for the ratings-based approach (including any credit-enhancing I/O strips that were not deducted from Tier 1 capital) are subject to a dollar-for-dollar capital charge. In no event will this combined capital charge exceed the face amount of a banking organization's residual interests.

a. *Concentration Limit Capital Charge.* The final rule imposes a concentration limit on a subset of residual interests. It limits the inclusion of interest-only strips that serve in a credit-enhancing capacity (credit-enhancing I/O strips), whether retained or purchased, to 25% of Tier 1 capital for regulatory capital purposes (see discussion below at III.B.4).

For regulatory capital purposes only, any amount of credit-enhancing I/O strips that exceeds the 25% limit will be deducted from Tier 1 capital and from assets. Credit-enhancing I/O strips that are not deducted from Tier 1 capital, along with all other residual interests not subject to the concentration limit are

[15] Id.

[16] The definitions of residual interests and credit-enhancing I/Os are discussed in Sections III.B.3 and 4, below.

subject to the dollar-for-dollar capital requirement (as described below). In calculating the capital requirement in this manner, banking organizations will not be required to hold capital for more than 100% of the amount of the residual interest. The following example illustrates the concentration calculation required for banking organizations that hold credit-enhancing I/O strips:

A banking organization has purchased and retained credit-enhancing I/O strips with a face amount of $100 on its balance sheet and Tier 1 capital of $320 (before any disallowed servicing assets, disallowed purchased credit card relationships, disallowed credit-enhancing I/O strips and disallowed deferred tax assets). To determine the amount of credit-enhancing I/O strips that fall within the concentration limit, the banking organization would multiply the Tier 1 capital of $320 by 25%, which is $80. The amount of credit-enhancing I/O strips that exceed the concentration limit, in this case $20, is deducted from Tier 1 capital and from assets. For risk-based capital purposes (but not for leverage capital purposes), the remaining $80 is then subject to the dollar-for-dollar capital charge, which is discussed below.

Of those organizations commenting on the proposed concentration limit, most believed that a concentration limit should not be included in the final rule. However, the narrower concentration limit is consistent with commenters' suggestions that only interest-only strips be included in this limit. Moreover, credit-enhancing I/O strips are not aggregated with any servicing assets or purchased credit card relationships for purposes of calculating the 25% concentration limit. In that respect, the concentration limit in the final rule is a less binding constraint than the proposed limit.

The agencies narrowed the scope of assets subject to the concentration limit to credit-enhancing interest-only strips in recognition of the fact that these assets generally serve in a first loss capacity and are typically the most vulnerable to significant write-downs due to changes in valuation assumptions. In addition, interest-only strips are the asset type most often associated with the creation of capital as a result of gain-on-sale accounting, which allows a banking organization to leverage the capital created based on the current recognition of uncertain future cash flows.

b. *Dollar-for-Dollar Capital Charge.* For risk-based capital purposes (but not for leverage capital purposes), all residual interests that do not qualify for the ratings-based approach (including retained and purchased credit-enhancing I/O strips that have not been deducted from Tier 1 capital) are assessed a dollar-for-dollar capital charge. This charge requires that banking organizations hold a dollar in capital for every dollar in residual interests, even if this capital requirement exceeds the full risk-based capital charge on the assets transferred. The agencies believe that the current limited capital requirement could, in certain instances, be insufficient given the risk inherent in large residual interest positions. Because these assets are a subordinated interest in the future cash flows of the securitized assets, they have a concentration of credit and prepayment risk that, depending upon the life of the underlying asset, makes them vulnerable to sudden and sizeable impairment. In addition, when given accounting recognition, certain residuals, such as retained credit-enhancing I/O strips, have the effect of creating capital, which may not be available to support these assets if write-downs become necessary. Recent experience has shown that residual interests can be among the riskiest assets on the balance sheet and, therefore, most deserving of a higher capital charge.

Continuing the above illustration for credit-enhancing I/O strips, once a banking organization deducts the $20 in disallowed credit-enhancing I/O strips, it must hold $80 in total capital for the $80 that represents the credit-enhancing I/O strips not deducted from Tier 1 capital. The $20 deducted from Tier 1 capital, plus the $80 in total risk-based capital required under the dollar-for-dollar treatment, equals $100, the face amount of the credit-enhancing I/O strips. Banking organizations may apply a net-of-tax approach to any credit-enhancing I/O strips that have been deducted from Tier 1 capital, as well as to the remaining residual interests subject to the dollar-for-dollar treatment. This calculation is illustrated in the preamble of the Residuals Proposal at 65 FR 57998. Under this method, a banking organization is permitted, but not required, to net the deferred tax liabilities recorded on its balance sheet, if any, that are associated with the residual interests. This may result in a banking organization holding less than 100% capital against residual interests.

Several commenters on the Residuals Proposal opposed the proposed capital treatment, believing that concerns associated with residual interests should be handled on a case-by-case basis under the agencies' existing supervisory authority. These commenters often referred to the Securitization Guidance, which highlights the supervisory concerns associated with residual interests.

The agencies believe that a minimum capital standard that more closely aligns capital with risk, along with supervisory review, is the appropriate course of action in dealing with residual interests. The agencies remain concerned with the credit risk exposure associated with these deeply subordinated assets, particularly subinvestment grade and unrated residual interests. The lack of an active market makes these assets difficult to value and relatively illiquid.

Most commenters considered the dollar-for-dollar risk-based capital treatment to be overly broad and too harsh, particularly when applied to higher quality residual interests. Commenters also were concerned that the proposed treatment could increase the capital requirement for a residual interest above the capital requirement for the transferred assets when they were held on the banking organization's balance sheet.

The agencies have revised the Residuals Proposal in response to some of the industry's concerns. The agencies understand that the dollar-for-dollar capital requirement could result in a banking organization holding more capital on residual interests than on the underlying assets had they not been sold. However, in many cases the relative size of the retained exposure by the originating banking organization reveals additional market information about the quality of the securitized asset pool. To facilitate a transaction in a manner that meets with market acceptance, the securitization sponsor will often increase the size of the residual. This practice is often indicative of the quality of the underlying assets in the pool. In other words, large residual positions often signal the lower credit quality of the sold assets. Further, a banking organization's use of gain-on-sale accounting affords it the opportunity to create capital, the amount of which is related to a residual interest that may not be worth its reported carrying value. Thus, to mitigate the effects of these gains, the final rule requires banks to hold dollar-for-dollar capital against the related assets.

Commenters suggested several alternative capital treatments such as using the ratings based approach presented in the 2000 Recourse Proposal to set capital requirements for residual interests, excluding certain types of assets from the dollar-for-dollar treatment, and revising the existing capital treatment by requiring additional

capital only against the gain-on-sale ''asset.'' Other commenters proposed to limit the maximum capital requirement to the full capital charge plus any gain-on-sale amount.

The agencies have decided not to alter the dollar-for-dollar capital charge for residual interests that are unrated or rated B or below, although certain residual interests rated BB or better will be eligible for the ratings-based approach.[17] Certain types of assets were not excluded from the definition of ''residual interest'' because every residual reflects a concentration of credit risk and is, therefore, subject to valuation concerns associated with estimating future losses. Further, gain-on-sale accounting, while a concern, was not the only criterion in the agencies' determination of a suitable method for calculating the capital charge for residual interests. Basing the capital charge on the gain-on-sale amount would have made the rule more complex, and would not necessarily result in the maintenance of adequate capital for a residual interest since the gain-on-sale amount can be significantly less than the carrying value of the residual.

B. Definitions and Scope of the Final Rule

1. Recourse

The final rule defines the term ''recourse'' to mean an arrangement in which a banking organization retains, in form or in substance, the credit risk in connection with an asset sale in accordance with generally accepted accounting principles, if the credit risk exceeds a *pro rata* share of the banking organization's claim on the assets. The 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 sales.

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''). With the adoption of a definition for recourse in the final rule, the cross-reference to the Call Report instructions in the guidelines is no longer necessary and has been removed. The OTS capital regulation currently provides a definition of the term ''recourse,'' which has also been revised.

Several commenters sought clarification as to whether second lien positions constitute recourse. While second liens are subordinate to first liens, the agencies believe that second liens will not, in most instances, constitute recourse. Second mortgages or home equity loans generally will not be considered recourse arrangements unless they actually function as credit enhancements.

Commenters also requested clarification that third-party enhancements, e.g. insurance protection, purchased by the originator of a securitization for the benefit of investors do not constitute recourse. The agencies generally agree. The purchase of enhancements for a securitization, where the banking organization is completely removed from any credit risk will not, in most instances, constitute recourse. However, if the purchase or premium price is paid over time and the size of the payment is a function of the third-party's loss experience on the portfolio, such an arrangement indicates an assumption of credit risk and would be considered recourse.

2. Direct Credit Substitute

The definition of ''direct credit substitute'' complements the definition of recourse. The term ''direct credit substitute'' refers to an arrangement in which a banking organization assumes, in form or in substance, credit risk associated with an on- or off-balance sheet asset or exposure that was not previously owned by the banking organization (third-party asset) and the risk assumed by the banking organization exceeds the *pro rata* share of the banking organization's interest in the third-party asset. As revised, it also explicitly includes 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 purchased subordinated interests, such as credit-enhancing I/O strips, are also residual interests for regulatory capital purposes (see discussion in section III.B.4).

3. Residual Interests

The agencies define residual interests in the final rule as any on-balance sheet asset that represents an interest (including a beneficial interest) created by a transfer that qualifies as a sale (in accordance with generally accepted accounting principles) of financial assets, whether through a securitization or otherwise, and that exposes a banking organization to any credit risk directly or indirectly associated with the transferred asset that exceeds a *pro rata* share of that banking organization's claim on the asset, whether through subordination provisions or other credit enhancement techniques. Residual interests do not include interests purchased from a third party, except for credit-enhancing interest-only strips. Examples of these types of assets include credit-enhancing interest-only strips receivable; spread accounts; cash collateral accounts; retained subordinated interests; accrued but uncollected interest on transferred assets that, when collected, will be available to serve in a credit-enhancing capacity; and similar on-balance sheet assets that function as a credit enhancement. The functional-based definition reflects the fact that securitization structures vary in the way they use certain assets as credit enhancements. Therefore, residual interests include any retained on-balance sheet asset that functions as a credit enhancement in a securitization, regardless of how a banking organization refers to the asset in its financial or regulatory reports. In addition, due to their similar risk profile, purchased credit-enhancing I/O strips are residual interests for regulatory capital purposes.

Some commenters thought that the definition of residual interest was too broad and captured assets that are not subject to valuation concerns. The agencies have considered these comments and, as a result, have refined the definition of residual interest in the final rule. In general, the definition of residual interests includes only an on-balance sheet asset that represents an interest created by a transfer of financial assets treated as a sale under GAAP. Interests retained in a securitization or transfer of assets accounted for as a financing under GAAP are generally excluded from the residual interest definition and capital treatment. In the case of GAAP financings, the transferred assets remain on the transferring banking organization's balance sheet and are, therefore, directly included in both the leverage and risk-based capital calculations. Further, when a transaction is treated as a financing, no gain is recognized from an accounting standpoint, which serves to mitigate some of the agencies' concerns. The agencies, however, will monitor securitization transactions that are accounted for as financings under GAAP and will factor into the banking organization's capital adequacy

[17] Credit-enhancing I/Os are not eligible for the ratings-based approach.

determination the risk exposures being assumed or retained in connection with a securitization transaction.

Some commenters stated that sellers' interests should not constitute residual interests because they do not involve a subordinated interest in a stream of cash flows, but rather a *pro-rata* interest. The agencies agree that sellers' interests generally do not function as a credit enhancement and should not be captured by the rule. Thus, if a seller's interest shares losses on a pro rata basis with investors, such an interest would not be a residual interest for purposes of the rule. However, banking organizations should recognize that sellers' interests that are structured to absorb a disproportionate share of losses will be residual interests and subject to the capital treatment described in the final rule.

Other commenters suggested that overcollateralization accounts are not residual interests because the banking organization does not suffer a potential loss from the assets transferred. They argue that certain residual interests, such as interest-only strips, are subject to valuation concerns that might lead to losses. However, other assets, such as overcollateralization or spread accounts, do not present the same level of valuation concerns and, therefore, should not be included in the definition of residual interest.

Overcollateralization and spread accounts are susceptible to the potential future credit losses within the loan pools that they support and, thus, are subject to valuation inaccuracies. Further, the agencies do not want to encourage arbitrage of the final rule by affording banking organizations the opportunity to retain a subordinated position in an asset labeled ''overcollateralization'' when that asset represents the same level of credit risk as another residual interest, just otherwise named. As a result, the definition of residual interest continues to include overcollateralization. The agencies agree that spread accounts and overcollateralization that do not meet the definition of credit-enhancing interest-only strips generally do not expose a banking organization to the same level of risk as credit-enhancing interest-only strips, and thus, have excluded them from the concentration limit. The agencies also believe that where a banking organization provides additional loans to a securitization at inception, but does not book as an asset a beneficial interest for the present value of the future cash flows from these loans, the mere contribution of excess assets, although it constitutes a credit enhancement, will not constitute a residual interest under the final rule because the banking organization has no on-balance sheet asset that is susceptible to a write-down.

The capital treatment designated for a residual interest will apply when a banking organization effectively retains the risk associated with that residual interest, even if the residual is sold. The agencies intend to look to the economic substance of the transaction to determine whether the banking organization has transferred the risk associated with the residual interest exposure. Banking organizations that transfer the risk on residual interests, either directly through a sale, or indirectly through guarantees or other credit risk mitigation techniques, and then reassume this risk in any form will be required to hold risk-based capital as though the residual interest remained on the banking organization's books. For example, if a banking organization sells an asset that is an on-balance sheet credit enhancement to a third party and then writes a credit derivative to cover the credit risk associated with that asset, the selling banking organization must continue to risk weight, and hold capital against, that asset as a residual as if the asset had not been sold.

4. Credit-Enhancing Interest-Only Strips

A credit-enhancing I/O strip is defined in the final rule 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 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.'' Thus, credit-enhancing I/O strips include any balance sheet asset that represents the contractual right to receive some or all of the remaining interest cash flow generated from assets that have been transferred into a trust (or other special purpose entity), after taking into account trustee and other administrative expenses, interest payments to investors, servicing fees, and reimbursements to investors for losses attributable to the beneficial interests they hold, as well as reinvestment income and ancillary revenues [18] on the transferred assets. Credit-enhancing I/O strips are generally carried on the balance sheet at the present value of the expected net cash flow that the banking organization reasonably expects to receive in future periods on the assets it has securitized, adjusted for some level of prepayments if relevant to that asset class, and discounted at an appropriate market interest rate. Typically, when assets are transferred in a securitization transaction that is accounted for as a sale under GAAP, the accounting recognition given to the credit-enhancing I/O strip on the seller's balance sheet results in the recording of a gain on the portion of the transferred assets that has been sold. This gain is recognized as income, thus increasing the banking organization's capital position. 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. For example, including some principal payments with interest and fee cash flows will not otherwise negate the regulatory capital treatment of that asset as a credit-enhancing I/O strip. Credit-enhancing I/O strips include both purchased and retained interest-only strips that serve in a credit-enhancing capacity, even though purchased I/O strips generally do not result in the creation of capital on purchaser's balance sheet.

5. 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 synthetic securitization. With the issuance of this final rule, the agencies reaffirm the validity of the structural and risk-management requirements of the December 1999 guidance on synthetic securitizations issued by the Board and the OCC,[19] while modifying the risk-based capital treatment detailed therein with the treatment presented in this final rule.

6. Credit-Enhancing 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

[18] According to FASB Statement No. 140, ''Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,'' ancillary revenues include such revenues as late charges on the transferred assets.

[19] *See*, Banking Bulletin 99–43, December, 1999 (OCC); SR Letter 99–32, Capital Treatment for Synthetic CLOs, November 17, 1999 (Board).

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 2000 Recourse Proposal addressed 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. To the extent a banking organization's representations and warranties function as credit enhancements to protect asset purchasers or investors from credit risk, the final rule treats them as recourse or direct credit substitutes.

The final rule is consistent with the agencies' longstanding recourse treatment of representations and warranties that effectively guaranty performance or credit quality of transferred loans. However, the agencies 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, and are excluded from the definitions of recourse and direct credit substitute. 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, fraud or misrepresentation.

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 operational risks are effectively managed.

The final rule requires recourse or direct credit substitute 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. Warranties such as these, which make representations about the future value of a loan or related collateral constitute an enhancement of the loan transferred and, thus, are recourse arrangements or direct credit substitutes. One commenter suggested that a representation that the seller ''has no knowledge'' of circumstances that could cause a loan to be other than investment quality is an operational warranty. The agencies agree that if a seller represents that it has no knowledge of the existence of such circumstances at the time that the loans are transferred the representation would not be recourse.

Commenters sought clarification of the agencies' statement in the 2000 Recourse Proposal that early-default clauses are recourse. Early-default clauses typically give the purchaser of a loan the right to return the loan to the seller if the loan becomes 30 or more days delinquent within a stated period after the transfer—four months after transfer, for example. Once the stated period has expired, the early-default clause will no longer trigger recourse treatment, provided that there is no other provision that constitutes recourse.

Several commenters stated that early-default clauses are not recourse because they are designed to cover loans that, due to their non-payment within the first few months of origination, most likely contained underwriting deficiencies. Early-default clauses can allow for a reasonable but limited period of time for a purchaser to review loan file documentation. Therefore, the final rule specifically exempts from recourse treatment, for a limited period of time, these types of warranties on certain 1–4 family residential mortgage loans. The agencies have modified the definition of ''credit-enhancing representations and warranties'' to exclude warranties, such as early-default clauses and similar warranties that permit the return of qualifying 1–4 family residential first mortgage loans for a maximum period of 120 days from the date of transfer. To be excluded from the definition, however, these warranties must cover only 1–4 family residential mortgage loans that are eligible for the 50% risk weight and that were originated within 1 year of the date of transfer. All other early-default clauses, including those for periods of greater than 120 days on qualifying 1–4 family residential first mortgages, are recourse or direct credit substitutes.

The 2000 Recourse Proposal also sought comment on premium refund clauses. A premium refund clause is a warranty that obligates a seller who has sold a loan at a price in excess of par, *i.e.,* at a premium, to refund the premium, either in whole or in part, if the loan defaults or is prepaid within a certain period of time. Commenters responded that premium refund clauses are not recourse because they reflect interest rate risk, not credit risk.

Although premium refund clauses can be triggered as a result of prepayments, they can also be triggered by defaults. Accordingly, premium refund clauses are generally credit-enhancing representations and warranties under the final rule. However, the agencies have included an exception for premium refund clauses on U.S. government-guaranteed loans and qualifying 1–4 family first mortgage loans that impose a refund obligation on a seller for a period not to exceed 120 days from the date of transfer. These types of loans hold significantly reduced credit risk.

For those warranties not exempt from recourse or direct credit substitute treatment under the final rule, industry concerns about assets that are delinquent at the time of transfer or unsound originations may be dealt with by warranties directly addressing the condition of the asset *at the time of transfer* (*i.e.,* creation of an above described operational warranty) and compliance with stated underwriting standards. Alternatively, banking organizations might create warranties with exposure caps that would permit the banking organization to take advantage of the low-level recourse rule.

7. Clean-Up Calls

The final rule clarifies the agencies' longstanding interpretations on the use of clean-up calls in a securitization. A clean-up call is an option that permits a servicer or its affiliate (which may be the originator) to take investors out of their positions in a securitization before all of the transferred loans have been repaid. The servicer accomplishes this by repurchasing the remaining loans in the pool once the pool balance has fallen below some specified level. This option in a securitization raises longstanding agency concerns that a banking organization may implicitly assume a credit-enhancing position by

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

As a result, clean-up calls are treated generally as recourse and direct credit substitutes. However, because clean-up calls can also serve an administrative function in the operation of a securitization, the agencies have included a limited exemption for these options. Under the final rule, an agreement that permits a banking organization that is a servicer or an affiliate of the servicer to elect to purchase loans in a pool is not recourse or a direct credit substitute if the agreement permits the banking organization to purchase the remaining loans in a pool when the balance of those loans is equal to or less than 10 percent of the original pool balance. However, an agreement that permits the remaining loans to be repurchased when their balance is greater than 10 percent of the original pool balance is considered to be recourse or a direct credit substitute. The exemption from recourse or direct credit substitute treatment for a clean-up call of 10 percent or less recognizes the real market need to be able to call a transaction when the costs of keeping it outstanding are burdensome. However, to minimize the potential for using such a feature as a means of providing support for a troubled portfolio, a banking organization that exercises a clean-up call should not repurchase any loans in the pool that are 30 days or more past due. Alternatively, the banking organization should repurchase the loans at the lower of their estimated fair value or their par value plus accrued interest. Regardless of the size of the clean-up call, the agencies will closely scrutinize any transaction where the banking organization repurchases deteriorating assets for an amount greater than a reasonable estimate of their fair value and will take action accordingly.

8. Loan Servicing Arrangements

The definitions of ''recourse'' and ''direct credit substitute'' cover loan servicing arrangements if the banking organization, as servicer, is responsible for credit losses associated with the serviced loans. 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 and this reimbursement is not subordinate to other claims. To be excluded from recourse and direct credit substitute treatment, the banking organization, as servicer, should make an independent credit assessment of the likelihood of repayment of the servicer advance prior to advancing funds and should only make such an advance if prudent lending standards are met. Risk-based capital is assessed only against the amount of the cash advance, and the advance is assigned to the risk-weight category appropriate to the party obligated to reimburse the servicer.[20]

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. Otherwise, the servicer's obligation to make cash advances will not 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 enhancement.

Commenters responding to the 2000 Recourse Proposal generally supported the proposed definition of servicer cash advances. Some commenters, however, expressed concern over the description of ''insignificant'' nonreimbursed advances as advances on any one loan that are contractually limited to no more than 1% of the outstanding principal amount on that loan. They argued that this 1% limit would unfairly penalize smaller loans and was unnecessary.

The agencies suggested the 1% limit in the 2000 Recourse Proposal in response to commenters' requests for guidance from commenters on the 1997 Proposal. However, upon reconsideration, the agencies agree that the 1% limit is unnecessarily restrictive for smaller loans. Accordingly, the final rule does not contain this benchmark.

Banking organizations that act as servicers, however, should establish policies on servicer advances and use discretion in determining what constitutes an ''insignificant'' servicer advance. The agencies will monitor industry practice and may revisit the issue if this exemption from recourse treatment is used inappropriately. Further, the agencies will exercise their supervisory authority to apply recourse or direct credit substitute treatment to servicer cash advances that expose a banking organization acting as servicer to excessive levels of credit risk.

9. Interaction With Market Risk Rule

Some commenters responding to the 2000 Recourse Proposal and the Residuals Proposal asked for clarification of the treatment of a transaction covered by both the market risk rule and the recourse rule. This final rule generally applies to positions held in the banking book.[21] For banking organizations that comply with the market risk rules,[22] positions in the trading book arising from asset securitizations, including recourse obligations, residual interests, and direct credit substitutes, should be treated for risk-based capital purposes in accordance with those rules. However, these banking organizations remain subject to the 25 percent concentration limit for credit-enhancing I/O strips.

10. Reservation of Authority

Banking organizations are developing novel transactions that do not fit well into the risk-weight categories and credit conversion factors in the current 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 have clarified 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

[20] The Board has issued a notice of proposed rulemaking that considers whether a special purpose entity should be characterized as a bank affiliate and whether asset securitizations should be classified as covered transactions pursuant to section 23A of the Federal Reserve Act, 12 U.S.C. 371c. *See* ''Transactions between Banks and Their Affiliates'', 66 FR 24186, May 11, 2001 and 66 FR 33649, June 25, 2001. Any final rule resulting from this Proposal could affect the regulatory capital treatment of servicer cash advances.

[21] This rule applies also to banking organizations that hold positions in their trading book, but are not otherwise subject to the market risk rules.

[22] The OTS did not participate in the market risk rulemaking. As a result, certain OTS definitions—for example, the OTS's definition of ''face amount'';—differ from those of the other agencies.

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 regulatory capital standards. Under this authority, the agencies reserve the right to assign risk positions in securitizations to appropriate risk categories on a case-by-case basis if the credit rating of the risk position is determined to be inappropriate.

11. Alternative Capital Calculation for Small Business Obligations

Certain commenters noted that the capital treatment in the Residuals Proposal would have a significant negative impact on banking organizations' small business lending. According to these commenters, the dollar-for-dollar capital requirement and concentration limits for residual interests arising from asset securitizations under the Residuals Proposal would apply to asset securitizations involving the transfer of small business obligations. These commenters concluded that, unless the Residuals Proposal is amended to exclude small business obligations from coverage, the capital treatment in the final rule would contravene section 208 of the CDRI Act. The final rule retains the alternative capital calculation for small business obligations that implements section 208 of the CDRI Act.

C. Ratings-Based Approach: Traded and Non-Traded 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 capital requirement for different credit enhancements or loss positions to reflect differences in the relative credit risk represented by the positions.

To address this issue, the agencies are implementing a multi-level, ratings-based approach to assess capital requirements on recourse obligations, residual interests (except credit-enhancing I/O strips), 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 to measure relative exposure to credit risk and 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 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 use of credit ratings in the final rule is similar to the 2000 Recourse Proposal. Although many commenters expressed concerns about specific aspects of the 2000 Recourse Proposal, commenters generally supported the goal of making the capital requirements for asset securitizations more rational and efficient, and viewed the 2000 Recourse Proposal as a positive step toward this goal. The agencies have made several changes to the 2000 Recourse Proposal and Residual Proposal in response to commenters' concerns and based on further consideration of the issues.

Several commenters on the 2000 Recourse Proposal expressed concern over reliance on external rating agency ratings for the purposes of assessing risk-based capital charges for banking organizations. They asserted that credit ratings are not intended to measure risks associated with regulatory capital and that, without market discipline imposed on them, the ratings may not be reliable for that purpose. They also noted an inherent conflict of interest between a rating agency's ability to objectively assign a rating upon which regulators can rely in imposing capital charges and one that measures the risks in a securitization for the banking organization who is paying for the rating.

Investors rely on ratings to make investment decisions. This reliance 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. Further, the use of a single rating will only be adequate under the ratings-based approach for a position that is traded. The agencies, however, reserve the 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 that an instrument poses to banking organizations.

Under the ratings-based approach, the capital requirement for a position is computed by multiplying the face amount of the position by the appropriate risk weight determined in accordance with the following tables.[23] The first chart shown below maps long-term ratings to the appropriate risk-weights under the final rule. In response to requests from commenters, the agencies have also included another chart (the second chart shown below) that maps short-term ratings for asset-backed commercial paper to the appropriate risk-weights under this rule.

Long-term rating category	Examples	Risk weight (In percent)
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	(1)

Short-term rating category	Examples	Risk weight (In percent)
Highest investment grade	A–1, P–1	20
Second highest investment grade	A–2, P–2	50
Lowest investment grade	A–3, P–3	100

[23] The rating designations (e.g., "AAA," "BBB," "A–1," and "P–1") used in the charts are illustrative only and do not indicate any preference for, or endorsement of, any particular rating agency designation system.

Short-term rating category	Examples	Risk weight (In percent)
Below investment grade	Not Prime	(1)

1 Not eligible for ratings-based approach.

The chart for short-term ratings is not identical to the long-term ratings table because the rating agencies do not assign short-term ratings using the same methodology as long-term ratings. Each short-term rating category covers a range of longer-term rating categories.[24] For example, a P–1 rating could map to a long-term rating as high as Aaa or as low as A3.

Under the final rule, the ratings-based approach is available for asset-backed securities,[25] recourse obligations, direct credit substitutes and residual interests (other than credit-enhancing I/O strips). The agencies have excluded credit-enhancing I/O strips from the ratings-based approach based on their high risk profile, discussed above at section III.B.4.

While the ratings-based approach is available for both traded and untraded positions, the rule applies different requirement to these positions. A traded position, for example, is only required to be rated by one rating agency. A position is defined as ''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 unaffiliated investors relying on the rating; or (2) an unaffiliated 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.

A few commenters expressed concern over the provision in the 2000 Recourse Proposal that allowed a banking organization to use the single highest rating obtained on a traded position, stating that doing so encourages rating-shopping. The agencies agree and, therefore, the final rule requires a banking organization to use the lowest single rating assigned to a traded position. Moreover, if a rating changes, the banking organization must use the new rating.

Rated, but untraded, asset-backed securities, recourse obligations, direct credit substitutes and residual interests may also be eligible for the ratings-based approach if they meet certain conditions. To qualify, the position must be rated by more than one rating agency, the ratings must be one category below investment grade or better for long-term positions (or investment grade or better for short-term positions) by all rating agencies providing a rating, the ratings must be publicly available, and the ratings must be based on the same criteria used to rate securities that are traded. If the ratings are different, the lowest single rating will determine the risk-weight category.

Recourse obligations and direct credit substitutes (other than residual interests) that do not qualify for the ratings-based approach (or the internal ratings, program ratings or computer program ratings approaches outlined below) receive ''gross-up'' treatment, that is, the banking organization holding the position must hold capital against the amount of the position plus all more senior positions, subject to the low-level exposure rule.[26] This grossed-up amount is placed into a risk-weight category according to the obligor or, if relevant, the guarantor or the nature of the collateral. The grossed-up amount multiplied by both the risk-weight and 8 percent is never greater than the full capital charge that would otherwise be imposed on the assets if they were on the banking organization's balance sheet.[27]

Residual interests that are not eligible for the ratings-based approach receive dollar-for-dollar treatment. Dollar-for-dollar treatment means, effectively, that one dollar in total risk-based capital must be held against every dollar of a residual interest, except for credit-enhancing I/Os that have already been deducted from Tier 1 capital under the concentration limit.[28] Thus, the capital requirement for residual interests is not limited by the 8 percent cap in place under the current risk-based capital system.

Finally, an unrated position that is senior or preferred in all respects (including collateralization and maturity) to a rated position that is traded is treated as if it had the rating assigned to the rated position. The banking organization, however, must satisfy its supervisory agency that such treatment is appropriate. Senior unrated positions qualify for the risk weighting of the subordinated rated positions in the same securitization transaction as long as the subordinated rated position (1) is traded and (2) remains outstanding for the entire life of the unrated position, thus providing full credit support for the term of the unrated position.

D. Unrated Positions

In response to the 2000 Recourse Proposal and earlier proposals, commenters expressed concern over the expense and inefficiency of requiring the purchase of ratings to qualify for the ratings-based approach and advocated alternative approaches. In response to these concerns, the final rule incorporates three alternative approaches for determining the capital

24 *See*, for example, Moody's Global Ratings Guide, June 2001, p.3.

25 Similar to the banking agencies' 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. Currently, OTS also includes most interest-only and principal-only strips in the 100% risk-weight category. *See* 12 CFR 567.6(a)(1)(iv) (introductory statement) and (a)(1)(iv)(M). However, certain high-quality stripped mortgage-related securities are eligible for a 20% risk weight under the OTS' capital standards. OTS recently proposed to conform its capital treatment for high-quality stripped mortgage-related securities to that of other agencies, and received not comments in opposition to this change. *See* 66 FR 15049, March 15, 2001. Accordingly, OTS in conforming these aspects of its rule to those of the other agencies.

26 ''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 obligor or, if relevant, the guarantor or the nature of the collateral. For example, if a banking organization retains a first-loss position (other than a residual interest) 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 exposure 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).

27 For assets that are assigned to the 100 percent risk-weight category, the minimum capital charge is 8 percent of the amount of assets transferred, and banking organizations are required to hold 8 cents of capital for every dollar of assets transferred with recourse. For assets that are assigned to the 50 percent risk-weight category, the minimum capital charge is 4 cents of capital for every dollar of assets transferred with recourse.

28 Residual interests that are retained or purchased credit-enhancing I/O strips are first subject to a capital concentration limit of 25 percent of Tier 1 capital. For risk-based capital purposes (but not for leverage capital purposes), once this concentration limit is applied, a banking organization must then hold dollar-for-dollar capital against the face amount of credit-enhancing I/O strips remaining.

requirements for certain unrated direct credit substitutes and recourse obligations. Under each of these approaches, the banking organization must satisfy its supervisory agency that the use of the approach is appropriate for the particular banking organization and for the exposure being evaluated. The final rule limits, however, the risk weight that may be applied to an exposure under these alternative approaches to a minimum of 100%.

Under the 2000 Recourse Proposal, only direct credit substitutes could qualify for beneficial risk-weighting using the three alternatives to external ratings (i.e., internal ratings, program ratings, and computer programs). Commenters questioned the agencies' limitation of the application of these alternative approaches to direct credit substitutes. After considering the arguments for extending the application of these approaches to recourse obligations, the agencies have decided not to permit the internal ratings-based approach to apply to any positions other than direct credit substitutes issued in connection with an asset-backed commercial paper program. Industry research and empirical evidence indicates that these positions are more likely than recourse positions to be of investment-grade credit quality, and that the banking organizations providing these direct credit substitutes are more likely to have internal risk rating systems for these credit enhancements that are sufficiently reliable for risk-based capital calculations.

However, the agencies have reconsidered their position with respect to qualifying program ratings and computer program ratings. The final rule extends beneficial risk-weighting treatment, through the use of qualifying program and computer ratings, to off-balance sheet recourse obligations to accommodate structured finance programs. By extending this treatment to off-balance sheet recourse obligations the final rule facilitates the structuring of these programs in a more efficient manner. The agencies believe this result is appropriate because of the similarity of economic risks between off-balance sheet direct credit substitutes and off-balance sheet recourse obligations.

The final rule, however, does not extend the use of internal ratings, program ratings or computer program ratings to residual interests. Such a change would not facilitate existing asset-backed commercial paper programs and structured finance programs, which generally do not book any on-balance sheet residuals. Further, residual interests by their nature are generally illiquid, hard-to-value assets, often with limited performance history. These characteristics make determining internal capital requirements difficult. The agencies also believe that the economic risk differs between residual interests and off-balance sheet recourse and direct credit substitute exposures. Therefore, based on the risks associated with residual interests, the agencies have decided for the present not to allow banking organizations to use internal ratings, program ratings or computer programs to apply a risk-based capital treatment more favorable than a dollar-for-dollar capital requirement to these positions.

The agencies will continue to evaluate the effectiveness and reliability of these alternative approaches for assessing regulatory capital at banking organizations and may revisit this issue if, over time, new information indicates that reconsideration is warranted.

1. Use of Banking Organizations' Internal Risk Ratings

The final rule permits 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 such a credit enhancement 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 toward potential adoption of a broader use of internal risk ratings as discussed in the Basel Committee's June 1999 and January 2001 Consultative Papers on a new Basel Capital Accord.

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 or traded. 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 non-traded 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 potentially 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 in asset-backed commercial paper programs 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. A banking organization engaged in asset-backed commercial paper securitization activities that wishes to use the internal risk ratings approach must be able to demonstrate to the satisfaction of its primary regulator, prior to relying upon its use, that the bank's internal credit risk rating system is 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 the 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 final rule. 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.

If a banking organization's rating system is no longer found to be adequate, the banking organization's primary regulator may preclude the banking organization 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 had applied to previous transactions for purposes of determining the banking organization's regulatory capital requirements.

2. Ratings of Specific Positions in Structured Financing Programs

Under the final rule, a banking organization may use a rating obtained from a rating agency for unrated direct credit substitutes or recourse obligations (but not residual interests) in structured finance programs 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 traded positions. 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 or recourse exposure.

To use this approach, a banking organization must demonstrate to its primary regulator that it is reasonable and consistent with the standards of this final rule 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 final rule 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 final rule 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 can be used to qualify a direct credit substitute or recourse obligation (but not a residual interest) 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%.

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

The agencies will also allow banking organizations, particularly those with limited involvement in securitization activities, to rely on qualifying credit assessment computer programs that the rating agencies have developed to rate otherwise unrated direct credit substitutes and recourse obligations (but not residual interests) in asset securitizations.

To qualify for use by a banking organization for risk-based capital purposes, a computer program's credit assessments must correspond credibly and reliably to the rating standards of the rating agencies for traded positions in securitizations. A banking organization must demonstrate the credibility of the computer program in the financial markets, which would generally be shown by the significant use of the computer program by investors and other market participants for risk assessment purposes. A banking organization must also demonstrate the reliability of the program in assessing credit risk.

A banking organization may use a computer program for purposes of applying the ratings-based approach under this final rule only if the banking organization satisfies its primary regulator that the program results in credit assessments that credibly and reliably correspond with the ratings of traded positions by the rating agencies. The banking organization should also demonstrate to its primary regulator's satisfaction that the program was designed to apply to its particular direct credit substitute or recourse exposure and that it has properly implemented the computer program. 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 can be used to qualify a direct credit substitute or recourse obligation (but not a residual interest) 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%.

IV. Effective Date of the Final Rule

This final rule is effective January 1, 2002, a date that comports with the delayed effective date requirements of both the Administrative Procedure Act (APA) and the CDRI Act.[29] Any transaction covered by this final rule that is settled on or after that date is subject to the capital requirements established by the rule. Banking organizations that have entered into transactions prior to the effective date of

[29] *See* 5 U.S.C. 553(d) (APA provision prescribing 30-day delayed effective date); 12 U.S.C. 4802(b) (CDRI provision requiring that a regulation take effect on the first day of the calendar quarter following publication in final form if the regulation imposes ''reporting, disclosures or other new requirements'' on insured depository institutions.)

the final rule may elect early adoption, as of November 29, 2001, of any provision of the final rule that results in a reduced risk-based capital requirement. Conversely, banking organizations that enter into transactions prior to the effective date of this final rule that result in increased regulatory capital requirements may delay the application of this rule to those transactions until December 31, 2002.

Although the Residual Proposal indicated that the agencies intended to permit banking organizations to continue to apply existing capital rules to certain asset securitizations for up to two years after the effective date of the final rule, the agencies believe that the one year effective date should give banking organizations ample time to bring their capital requirements in line with the economic risks that they have already assumed through their securitization activities. The agencies have, through the issuance of supervisory guidance and four separate notices of proposed rulemaking, identified the risks to banking organizations from securitizations and demonstrated the agencies' concern over the management of these risks by banking organizations. These rulemakings and guidance have placed the industry on notice that, among other things, the agencies have concluded that the securitization activities of banking organizations often expose them to greater economic risk than their capital levels reflect. Therefore, this final rule requires that all transactions, whether entered into before its effective date or not, be subject to the capital requirements stated in the rule, but allows for flexibility in the time by which that must occur.

V. Miscellaneous Changes

Each of the agencies has made miscellaneous changes to its proposed regulatory text to conform its rule to the texts of the other agencies. In addition, the agencies have made revisions to existing rules to appropriately accommodate the revised treatment of recourse, direct credit substitutes and residual interests.

VI. Regulatory Analysis

A. Regulatory Flexibility Act

OCC: Pursuant to section 605(b) of the Regulatory Flexibility Act, the OCC certifies that this final rule will not have a significant impact on a substantial number of small entities. 5 U.S.C. *601 et seq.* The provisions of this final rule 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 final rule 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 (5 U.S.C. 601 *et seq.*) the FDIC hereby certifies that the final rule will not have a significant economic 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 final rule will not have a significant impact on a substantial number of small entities. The provisions of this final rule that increase capital requirements for thrifts—the provisions on residual interests and certain direct credit substitutes (*e.g.*, financial standby letters of credit)—are unlikely to affect small savings associations. Current TFR data reveal that few small savings associations hold residual interests and that no small thrift holds residual interests in excess of 25 percent of core capital. Further, the application of the revised capital requirements to existing residual interests will not result in a change in the capital category of any small thrift. Few small savings associations issue standby letters of credit. In addition, virtually all of the standby letters of credit that are issued by small thrifts will not be subject to an increased capital requirement since these positions will continue to be eligible for lower risk weights under the alternative approaches outlines in the final rule. Accordingly, OTS concludes that a regulatory flexibility analysis is not required.

B. Paperwork Reduction Act

The agencies have determined that this final rule 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.*).

C. Executive Order 12866

OCC: The OCC has determined that this final rule 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 treatment of residual interests largely will be offset by the ability of those banks to reduce their capital requirement in accordance with the ratings-based approach.

OTS: The Director of the OTS has determined that this final rule does not constitute a "significant regulatory action" under Executive Order 12866. The final rule prescribes ratings-based and other alternative approaches that are likely to reduce the risk-based capital requirement for most recourse obligations and direct credit substitutes. The rule will, however, increase capital requirements for certain direct credit substitutes (*e.g.*, standby letters of credit) and residual interests. OTS has reviewed current TFR data to determine whether current OTS-regulated institutions hold these positions in significant amounts. These data indicate that, while these institutions hold some residual interests, most standby letters of credit issued by thrifts continue to be eligible for a lower risk weight under one of the alternative approaches outlined in the final rule. OTS has analyzed the additional cost of capital that will be incurred by thrift institutions that hold residual interests and direct credit substitutes that are subject to increased capital requirements. Based on this analysis, it has concluded that the likely increases to the industry's cost of capital will not have a significant impact on the economy, as described in the Executive Order.

D. Unfunded Mandates Reform Act of 1995

OCC: Section 202 of the Unfunded Mandates Reform Act of 1995, Pub. L. 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 has determined that this final 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 has not prepared a budgetary impact statement or specifically addressed the regulatory alternatives considered. As discussed in the preamble, this final rule 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, residual interests and direct credit substitutes.

OTS: Section 202 of the Unfunded Mandates Reform Act of 1995, Pub. L. 104–4 (Unfunded Mandates Act), requires an agency to 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. As discussed in the preamble, the final rule prescribes ratings-based and other alternative approaches that are likely to reduce the risk-based capital requirement for most recourse obligations and direct credit substitutes. The rule will, however, increase capital requirements for certain direct credit substitutes (*e.g.*, standby letters of credit) and residual interests. OTS has reviewed current TFR data to determine whether current OTS-regulated institutions hold these positions in significant amounts. These data indicate that, while these institutions hold some residual interests, most standby letters of credit issued by thrifts continue to be eligible for a lower risk weight under one of the alternative approaches outlined in the final rule. OTS has analyzed the additional cost of capital that will be incurred by thrift institutions that hold residual interests and direct credit substitutes that are subject to increased capital requirements. Based on this analysis, it has concluded that the likely increases to the industry's cost of capital will not 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.

E. Plain Language

The 2000 Recourse Proposal and the Residuals Proposal sought comment on the agencies' compliance with the ''plain language'' requirement of section 722 of the Gramm-Leach-Bliley Act (12 U.S.C. 4809). No comments were received.

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 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. A heading is added to newly designated paragraph (a);

C. The second and third sentences in the newly designated paragraph (a) are revised; and

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

§ 3.4 Reservation of authority.

(a) *Deductions from capital.* * * * Similarly, the OCC may find that a particular intangible asset, deferred tax asset or credit-enhancing interest-only strip need not be deducted from Tier 1 or Tier 2 capital. Conversely, the OCC may find that a particular intangible asset, deferred tax asset, credit-enhancing interest-only strip or other Tier 1 or Tier 2 capital component has characteristics or terms that diminish its contribution to a bank's ability to absorb losses, and may require the deduction from Tier 1 or Tier 2 capital of all of the component or of a greater portion of the component than is otherwise required.

(b) *Risk weight categories.* Notwithstanding the risk categories in sections 3 and 4 of appendix A to this part, the OCC will look to the substance of the transaction and 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 appendix A to Part 3, revise all references to ''financial guarantee-type standby letter of credit'' to read ''financial standby letter of credit''.

4. In section 2 of appendix A,

A. Remove the word ''and'' at the end of paragraph (c)(1)(ii);

B. Revise paragraph (c)(1)(iii)(B);

C. Add a new paragraph (c)(1)(iv);

D. Footnote 6 is revised;

E. The second sentence of paragraph (c)(2)(i) is revised;

F. Paragraph (c)(4) is redesignated as paragraph (c)(5);

G. A new paragraph (c)(4) is added.

Appendix A to Part 3—Risk-Based Capital Guidelines

* * * * *

Section 2. Components of Capital

* * * * *

(c) * * *

(1) * * *

(iii) * * *

(B) 10% of Tier 1 capital, net of goodwill and all intangible assets other than purchased credit card relationships, mortgage servicing assets and non-mortgage servicing assets; and

(iv) Credit-enhancing interest-only strips (as defined in section 4(a)(3) of this appendix A), as provided in section 2(c)(4).

* * * * *

(2) * * *[6] * * *

(i) * * * Calculation of these limitations must be based on Tier 1 capital net of goodwill and all other identifiable intangibles, other than purchased credit card relationships, mortgage servicing assets and non-mortgage servicing assets.

* * * * *

(4) *Credit-enhancing interest-only strips.* Credit-enhancing interest-only strips, whether purchased or retained, that exceed 25% of Tier 1 capital must be deducted from Tier 1 capital. Purchased and retained credit-enhancing interest-only strips, on a non-tax adjusted basis, are included in the total amount that is used for purposes of determining whether a bank exceeds its Tier 1 capital.

(i) The 25% limitation on credit-enhancing interest-only strips will be based on Tier 1 capital net of goodwill and all identifiable intangibles, other than purchased credit card relationships, mortgage servicing assets and non-mortgage servicing assets.

(ii) Banks must value each credit-enhancing interest-only strip included in Tier 1 capital at least quarterly. The quarterly determination of the current fair value of the credit-enhancing interest-only strip must include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates.

(iii) Banks may elect to deduct disallowed credit-enhancing interest-only strips on a basis that is net of any associated deferred tax liability. Deferred tax liabilities netted in this manner cannot also be netted against deferred tax assets when determining the amount of deferred tax assets that are dependent upon future taxable income.

* * * * *

4. 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. Footnote 16 in paragraph (b)(2)(i) is revised;

G. Footnote 17 in paragraph (b)(2)(ii) is revised;

H. Paragraph (c) is removed; and

I. Paragraph (d) is removed.

* * * * *

Section 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 4 of this appendix A.

(1) * * *

(ii) Risk participations purchased in bankers' acceptances;

* * * * *

(2) * * *

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

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

* * * * *

5. Section 4 is redesignated Section 5.

6. A new Section 4 is added to read as follows:

* * * * *

Section 4. Recourse, Direct Credit Substitutes and Positions in Securitizations

(a) *Definitions.* For purposes of this section 4 of this appendix A, the following definitions apply:

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

(2) *Credit-enhancing interest-only strip* means 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 transferred assets; and

(ii) Exposes the bank to credit risk directly or indirectly associated with the transferred assets that exceeds its *pro rata* claim on the assets whether through subordination provisions or other credit enhancing techniques.

(3) *Credit-enhancing 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 protect investors from losses arising from credit risk in the assets transferred or the loans serviced. Credit-enhancing 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. Credit-enhancing representations and warranties do not include:

(i) Early-default clauses and similar warranties that permit the return of, or premium refund clauses covering, 1–4 family residential first mortgage loans (as described in section 3(a)(3)(iii) of this appendix A) for a period not to exceed 120 days from the date of transfer. These warranties may cover only those loans that were originated within 1 year of the date of transfer;

(ii) Premium refund clauses that cover assets guaranteed, in whole or in part, by the U.S. Government, a U.S. Government agency, or a U.S. Government-sponsored enterprise, provided the premium refund clauses are for a period not to exceed 120 days from the date of transfer; or

(iii) Warranties that permit the return of assets in instances of fraud,

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[6] Intangible assets are defined to exclude IO strips receivable related to these mortgage and non-mortgage servicing assets. See section 1(c)(14) of this appendix A. Consequently, IO strips receivable related to mortgage and non-mortgage servicing assets are not required to be deducted under section 2(c)(2) of this appendix A. However, credit-enhancing interest-only strips as defined in section 4(a)(3) are deducted from Tier 1 capital in accordance with section 2(c)(4) of this appendix A. Any non credit-enhancing IO strips receivable are subject to a 100% risk weight under section 3(a)(4) of this appendix A.

[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 4(b) of this appendix A.

[16] For purposes of this section 3(b)(2)(i), a ''performance-based standby letter of credit'' is 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 the account party in the performance of a non-financial or commercial obligation. Participations in performance-based standby letters of credit are treated in accordance with section 4 of this appendix A.

[17] Participations in commitments are treated in accordance with section 4 of this appendix A.

misrepresentation or incomplete documentation.

(4) *Direct credit substitute* means an arrangement in which a bank assumes, in form or in substance, credit risk associated with an on- or off-balance sheet asset or exposure that was not previously owned by the bank (third-party asset) and the risk assumed by the bank exceeds the *pro rata* share of the bank's interest in the third-party asset. If a bank has no claim on the third-party asset, then the bank's assumption of any credit risk is a direct credit substitute. Direct credit substitutes include:

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

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

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

(iv) Credit derivative contracts under which the bank assumes more than its *pro rata* share of credit risk on a third-party asset or exposure;

(v) Loans or lines of credit that provide credit enhancement for the financial obligations of a third party;

(vi) Purchased loan servicing assets if the servicer is responsible for credit losses or if the servicer makes or assumes credit-enhancing representations and warranties with respect to the loans serviced. Mortgage servicer cash advances that meet the conditions of section 4(a)(8)(i) and (ii) of this appendix A, are not direct credit substitutes; and

(vii) Clean-up calls on third-party assets. Clean-up calls that are 10% or less of the original pool balance and that are exercisable at the option of the bank are not direct credit substitutes.

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

(6) *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.

(7) *Financial asset* means cash or other monetary instrument, evidence of debt, evidence of an ownership interest in an entity, or a contract that conveys a right to receive or exchange cash or another financial instrument from another party.

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

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

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

(9) *Mortgage servicer cash advance* means funds that a residential 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:

(i) 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

(ii) For any one loan, the servicer's obligation to make nonreimbursable advances is contractually limited to an insignificant amount of the outstanding principal amount of that loan.

(10) *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.

(11) *Recourse* means a bank's retention, in form or in substance, of any credit risk directly or indirectly associated with an asset it has sold that exceeds a *pro rata* share of that bank's claim on the asset. If a bank has no claim on a sold asset, then the retention of any credit risk 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:

(i) Credit-enhancing representations and warranties made on transferred assets;

(ii) Loan servicing assets retained pursuant to an agreement under which the bank will be responsible for losses associated with the loans serviced. Mortgage servicer cash advances that meet the conditions of section 4(a)(8)(i) and (ii) of this appendix A, are not recourse arrangements;

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

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

(v) Loan strips sold without contractual recourse where the maturity of the transferred portion of the loan is shorter than the maturity of the commitment under which the loan is drawn;

(vi) Credit derivatives issued that absorb more than the bank's *pro rata* share of losses from the transferred assets; and

(vii) Clean-up calls. Clean-up calls that are 10% or less of the original pool balance and that are exercisable at the option of the bank are not recourse arrangements.

(12) *Residual interest* means any on-balance sheet asset that represents an interest (including a beneficial interest) created by a transfer that qualifies as a sale (in accordance with generally accepted accounting principles) of financial assets, whether through a securitization or otherwise, and that exposes a bank to any credit risk directly or indirectly associated with the transferred asset that exceeds a *pro rata* share of that bank's claim on the asset, whether through subordination provisions or other credit enhancement techniques. Residual interests generally include credit-enhancing interest-only strips, spread accounts, cash collateral accounts, retained subordinated interests (and other forms of overcollateralization) and similar assets that function as a credit enhancement. Residual interests further include those exposures that, in substance, cause the bank to retain the credit risk of an asset or exposure that had qualified as a residual interest before it was sold. Residual interests generally do not include interests purchased from a third party.

(13) *Risk participation* means a participation in which the originating party 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.

(14) *Securitization* means the pooling and repackaging by a special purpose entity of assets or other credit exposures that can be sold to investors. Securitization includes transactions that create stratified credit risk positions

whose performance is dependent upon an underlying pool of credit exposures, including loans and commitments.

(15) *Structured finance program* means 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. Structured finance programs allocate credit risks, generally, between the participants and credit enhancement provided to the program.

(16) *Traded position* means a position retained, assumed or issued in connection with a securitization that is externally rated, where there is a reasonable expectation that, in the near future, the rating will be relied upon by:

(i) Unaffiliated investors to purchase the position; or

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

(b) *Credit equivalent amounts and risk weights of recourse obligations and direct credit substitutes*—(1) *Credit-equivalent amount.* Except as otherwise provided, 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.

(2) *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.

(c) *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:

(1) 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 party 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 after considering any associated guarantees or collateral.

(2) In the case of a direct credit substitute in which the bank has acquired a risk participation, the acquiring bank's *pro rata* 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.

(3) In the case of a direct credit substitute that takes the form of a syndication where each bank or participating entity is obligated only for its *pro rata* share of the risk and there is no recourse to the originating entity, 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.

(d) *Externally rated positions: credit-equivalent amounts and risk weights.*—(1) *Traded positions.* With respect to a recourse obligation, direct credit substitute, residual interest (other than a credit-enhancing interest-only strip) or asset- or mortgage-backed security that is a "traded position" and that has received an external rating on a long-term position that is one grade below investment grade or better or a short-term position that is investment grade, the bank may multiply the face amount of the position by the appropriate risk weight, determined in accordance with Tables B or C of this Appendix A.[24] If a traded position receives more than one external rating, the lowest single rating will apply.

TABLE B

Long-term rating category	Examples	Risk weight (In 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

TABLE C

Short-term rating category	Examples	Risk weight (In percent)
Highest investment grade	A–1, P–1	20
Second highest investment grade	A–2, P–2	50
Lowest investment grade	A–3, P–3	100

[24] Stripped mortgage-backed securities or other similar instruments, such as interest-only or principal-only strips, that are not credit enhancing must be assigned to the 100% risk category.

(2) *Non-traded positions.* A recourse obligation, direct credit substitute, residual interest (but not a credit-enhancing interest-only strip) or asset- or mortgage-backed security extended in connection with a securitization that is not a ''traded position'' may be assigned a risk weight in accordance with section 4(d)(1) of this appendix A if:

(i) It has been externally rated by more than one NRSRO;

(ii) It has received an external rating on a long-term position that is one category below investment grade or better or a short-term position that is investment grade by all NRSROs providing a rating;

(iii) The ratings are publicly available; and

(iv) The ratings are based on the same criteria used to rate traded positions.

If the ratings are different, the lowest rating will determine the risk category to which the recourse obligation, residual interest or direct credit substitute will be assigned.

(e) *Senior positions not externally rated.* For a recourse obligation, direct credit substitute, residual interest or asset- or mortgage-backed security that is not externally rated but is senior or preferred in all features to a traded position (including collateralization and maturity), a bank may apply a risk weight to the face amount of the senior position in accordance with section 4(d)(1) of this appendix A, based upon the traded position, subject to any current or prospective supervisory guidance and the bank satisfying the OCC that this treatment is appropriate. This section will apply only if the traded position provides substantive credit support to the unrated position until the unrated position matures.

(f) *Residual Interests*—(1) *Concentration limit on credit-enhancing interest-only strips.* In addition to the capital requirement provided by section 4(f)(2) of this appendix A, a bank must deduct from Tier 1 capital all credit-enhancing interest-only strips in excess of 25 percent of Tier 1 capital in accordance with section 2(c)(2)(iv) of this appendix A.

(2) *Credit-enhancing interest-only strip capital requirement.* After applying the concentration limit to credit-enhancing interest-only strips in accordance with section (f)(1), a bank must maintain risk-based capital for a credit-enhancing interest-only strip equal to the remaining amount of the credit-enhancing interest-only strip (net of any existing associated deferred tax liability), even if the amount of risk-based capital required to be maintained exceeds the full risk-based capital requirement for the assets transferred. Transactions that, in substance, result in the retention of credit risk associated with a transferred credit-enhancing interest-only strip will be treated as if the credit-enhancing interest-only strip was retained by the bank and not transferred.

(3) *Other residual interests capital requirement.* Except as provided in sections (d) or (e) of this section, a bank must maintain risk-based capital for a residual interest (excluding a credit-enhancing interest-only strip) equal to the face amount of the residual interest that is retained on the balance sheet (net of any existing associated deferred tax liability), even if the amount of risk-based capital required to be maintained exceeds the full risk-based capital requirement for the assets transferred. Transactions that, in substance, result in the retention of credit risk associated with a transferred residual interest will be treated as if the residual interest was retained by the bank and not transferred.

(4) *Residual interests and other recourse obligations.* Where the aggregate capital requirement for residual interests (including credit-enhancing interest-only strips) and recourse obligations arising from the same transfer of assets exceed the full risk-based capital requirement for those assets, a bank must maintain risk-based capital equal to the greater of the risk-based capital requirement for the residual interest as calculated under sections 4(f)(1) through (3) of this appendix A or the full risk-based capital requirement for the assets transferred.

(g) *Positions that are not rated by an NRSRO.* A position (but not a residual interest) extended in connection with a securitization and that is not rated by an NRSRO may be risk-weighted based on the bank's determination of the credit rating of the position, as specified in Table D of this appendix A, multiplied by the face amount of the position. In order to qualify for this treatment, the bank's system for determining the credit rating of the position must meet one of the three alternative standards set out in section 4(g)(1)through (3) of this appendix A.

TABLE D

Rating category	Examples	Risk weight (In percent)
Investment grade	BBB, or better	100
One category below investment grade	BB	200

(1) *Internal risk rating used for asset-backed programs.* A direct credit substitute (but not a purchased credit-enhancing interest-only strip) is assumed by a bank in connection with an asset-backed commercial paper program sponsored by the bank and the bank is able to demonstrate to the satisfaction of the OCC, prior to relying upon its use, that the bank's internal credit risk rating system is adequate. Adequate internal credit risk rating systems usually contain the following criteria:

(i) 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;

(ii) 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;

(iii) 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;

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

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

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

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

(viii) 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

(ix) 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.

(2) *Program Ratings.* A direct credit substitute or recourse obligation (but not a residual interest) is assumed or retained by a bank in connection with a structured finance program and a NRSRO has reviewed the terms of the program 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 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. In order to rely on a program rating, 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. 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 position. 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.

(3) *Computer Program.* The bank is using an acceptable credit assessment computer program to determine the rating of a direct credit substitute or recourse obligation (but not a residual interest) extended in connection with a structured finance program. A NRSRO 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.

(h) *Limitations on risk-based capital requirements*—(1) *Low-level exposure rule.* If the maximum contractual exposure to loss retained or assumed by a bank is less than the effective risk-based capital requirement, as determined in accordance with section 4(b) of this appendix A, 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 exposure, less any recourse liability account established in accordance with generally accepted accounting principles. This limitation does not apply when a bank provides credit enhancement beyond any contractual obligation to support assets that it has sold.

(2) *Related on-balance sheet assets.* If an asset is included in the calculation of the risk-based capital requirement under this section 4 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 4 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 must both be separately risk weighted and incorporated into the risk-based capital calculation.

(i) *Alternative Capital Calculation for Small Business Obligations.* (1) *Definitions.* For purposes of this section 4(i):

(i) *Qualified bank* means a bank that:

(A) Is well capitalized as defined in 12 CFR 6.4 without applying the capital treatment described in this section 4(i), or

(B) Is adequately capitalized as defined in 12 CFR 6.4 without applying the capital treatment described in this section 4(i) and has received written permission from the appropriate district office of the OCC to apply the capital treatment described in this section 4(i).

(ii) *Recourse* has the meaning given to such term under generally accepted accounting principles.

(iii) *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.

(2) *Capital and reserve requirements.* Notwithstanding the risk-based capital treatment outlined in section 2(c)(4) and any other subsection (other than subsection (i)) of this section 4, with respect to a transfer of a small business loan or a lease of personal property with recourse that is a sale under generally accepted accounting principles, a qualified bank may elect to apply the following treatment:

(i) The bank establishes and maintains a non-capital reserve under generally accepted accounting principles sufficient to meet the reasonable estimated liability of the bank under the recourse arrangement; and

(ii) For purposes of calculating the bank's risk-based capital ratio, the bank includes only the face amount of its recourse in its risk-weighted assets.

(3) *Limit on aggregate amount of recourse.* The total outstanding amount of recourse retained by a qualified bank with respect to transfers of small business loans and leases of personal property and included in the risk-weighted assets of the bank as described in section 4(i)(2) of this appendix A may not exceed 15 percent of the bank's total capital after adjustments and deductions, unless the OCC specifies a greater amount by order.

(4) *Bank that ceases to be qualified or that exceeds aggregate limit.* If a bank ceases to be a qualified bank or exceeds the aggregate limit in section 4(i)(3) of this appendix A, the bank may continue to apply the capital treatment described in section 4(i)(2) of this appendix A to transfers of small business loans and leases of personal property that occurred when the bank was qualified and did not exceed the limit.

(5) *Prompt Corrective Action not affected.* (i) A bank shall compute its capital without regard to this section 4(i) for purposes of prompt corrective action (12 U.S.C. 1831o and 12 CFR part 6) unless the bank is an adequately or well capitalized bank (without applying the capital treatment described in this section 4(i)) and, after applying the capital treatment described in this section 4(i), the bank would be well capitalized.

(ii) A bank shall compute its capital without regard to this section 4(i) for purposes of 12 U.S.C. 1831o(g) regardless of the bank's capital level.

* * * * *

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: October 23, 2001.

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 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, 24a, 36, 92a, 93a, 248(a), 248(c), 321–338a, 371d, 461, 481–486, 601, 611, 1814, 1816, 1818, 1820(d)(9), 1823(j), 1828(o), 1831o, 1831p–1, 1831r–1, 1831w, 1835a, 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 of section II, the first five paragraphs of section II.A.1, and the first seven paragraphs of section II.A.2. are revised and footnote 5 is removed and reserved;

B. In section II.B., a new paragraph (i)(c) is added, section II.B.1.b. and footnote 14 are revised, new sections II.B.1.c. through II.B.1.g. are added, and section II.B.4. is revised;

C. In section III.A., a new undesignated fifth paragraph is added at the end of the section;

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

E. In section III.C., paragraphs 1 through 3, footnotes 25 through 39 are redesignated as footnotes 23 through 37, and paragraph 4 is revised;

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

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

H. In section IV.B., footnote 52 is removed; and

I. Attachment II is revised.

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

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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 instrument 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 instrument to instruments explicitly treated in the guidelines, the ability of the instrument to absorb losses while the bank operates as a going concern, the maturity and redemption features of the instrument, 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]

[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.

A. * * *

1. *Core capital elements (tier 1 capital).* The tier 1 component of a bank's qualifying capital must represent at least 50 percent of qualifying total capital and may consist of the following items that are defined as core capital elements:

(i) Common stockholders' equity;

(ii) Qualifying noncumulative perpetual preferred stock (including related surplus); and

(iii) Minority interest in the equity accounts of consolidated subsidiaries.

Tier 1 capital is generally defined as the sum of core capital elements[5] less goodwill, other intangible assets, and interest-only strips receivables that are required to be deducted in accordance with section II.B.1. of this appendix.

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2. *Supplementary capital elements (tier 2 capital).* The tier 2 component of a bank's qualifying capital may consist of the following items that are defined as supplementary capital elements:

(i) Allowance for loan and lease losses (subject to limitations discussed below);

(ii) Perpetual preferred stock and related surplus (subject to conditions discussed below);

(iii) Hybrid capital instruments (as defined below), and mandatory convertible debt securities;

(iv) Term subordinated debt and intermediate-term preferred stock, including related surplus (subject to limitations discussed below);

(v) Unrealized holding gains on equity securities (subject to limitations discussed in section II.A.2.e. of this appendix).

The maximum amount of tier 2 capital that may be included in a bank's qualifying total capital is limited to 100 percent of tier 1 capital (net of goodwill, other intangible assets, and interest-only strips receivables that are required to be deducted in accordance with section II.B.1. of this appendix).

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B. * * *

(i) * * *

(c) Certain credit-enhancing interest-only strips receivables—deducted from the sum of core capital elements in

[5] [Reserved]

accordance with sections II.B.1.c. through e. of this appendix.

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1. *Goodwill, other intangible assets, and residual interests.* * * *

b. *Other intangible assets.* i. All servicing assets, including servicing assets on assets other than mortgages (i.e., nonmortgage servicing assets), are included in this appendix as identifiable intangible assets. The only types of identifiable intangible assets that may be included in, that is, not deducted from, a bank's capital are readily marketable mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships. The total amount of these assets that may be included in capital is subject to the limitations described below in sections II.B.1.d. and e. of this appendix.

ii. The treatment of identifiable intangible assets set forth in this section generally will be used in the calculation of a bank's capital ratios for supervisory and applications purposes. However, in making an overall assessment of a bank's capital adequacy for applications purposes, the Board may, if it deems appropriate, take into account the quality and composition of a bank's capital, together with the quality and value of its tangible and intangible assets.

c. *Credit-enhancing interest-only strips receivables (I/Os).* i. Credit-enhancing I/Os are on-balance sheet assets that, in form or in substance, represent the contractual right to receive some or all of the interest due on transferred assets and expose the bank to credit risk directly or indirectly associated with transferred assets that exceeds a *pro rata* share of the bank's claim on the assets, whether through subordination provisions or other credit enhancement techniques. Such I/Os, whether purchased or retained, including other similar ''spread'' assets, may be included in, that is, not deducted from, a bank's capital subject to the limitations described below in sections II.B.1.d. and e. of this appendix.

ii. Both purchased and retained credit-enhancing I/Os, on a non-tax adjusted basis, are included in the total amount that is used for purposes of determining whether a bank exceeds the tier 1 limitation described below in this section. In determining whether an I/O or other types of spread assets serve as a credit enhancement, the Federal Reserve will look to the economic substance of the transaction.

d. *Fair value limitation.* The amount of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that a bank may include in capital shall be the lesser of 90 percent of their fair value, as determined in accordance with section II.B.1.f. of this appendix, or 100 percent of their book value, as adjusted for capital purposes in accordance with the instructions in the commercial bank Consolidated Reports of Condition and Income (Call Reports). The amount of I/Os that a bank may include in capital shall be its fair value. If both the application of the limits on mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships and the adjustment of the balance sheet amount for these assets would result in an amount being deducted from capital, the bank would deduct only the greater of the two amounts from its core capital elements in determining tier 1 capital.

e. *Tier 1 capital limitation.* i. The total amount of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that may be included in capital, in the aggregate, cannot exceed 100 percent of tier 1 capital. The aggregate of nonmortgage servicing assets and purchased credit card relationships are subject to a separate sublimit of 25 percent of tier 1 capital. In addition, the total amount of credit-enhancing I/Os (both purchased and retained) that may be included in capital cannot exceed 25 percent of tier 1 capital.[14]

ii. For purposes of calculating these limitations on mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships, and credit-enhancing I/Os, tier 1 capital is defined as the sum of core capital elements, net of goodwill, and net of all identifiable intangible assets other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships, prior to the deduction of any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed credit-enhancing I/Os (both purchased and retained), and any disallowed deferred-tax assets, regardless of the date acquired.

iii. Banks may elect to deduct disallowed mortgage servicing assets, disallowed nonmortgage servicing assets, and disallowed credit-enhancing I/Os (both purchased and retained) on a basis that is net of any associated deferred tax liability. Deferred tax liabilities netted in this manner cannot also be netted against deferred-tax assets when determining the amount of deferred-tax assets that are dependent upon future taxable income.

f. *Valuation.* Banks must review the book value of all intangible assets at least quarterly and make adjustments to these values as necessary. The fair value of mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships, and credit-enhancing I/Os also must be determined at least quarterly. This determination shall include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates or account attrition rates. Examiners will review both the book value and the fair value assigned to these assets, together with supporting documentation, during the examination process. In addition, the Federal Reserve may require, on a case-by-case basis, an independent valuation of a bank's intangible assets or credit-enhancing I/Os.

g. *Growing organizations.* Consistent with long-standing Board policy, banks experiencing substantial growth, whether internally or by acquisition, are expected to maintain strong capital positions substantially above minimum supervisory levels, without significant reliance on intangible assets or credit-enhancing I/Os.

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4. *Deferred-tax assets.* a. The amount of deferred-tax assets that is dependent upon future taxable income, net of the valuation allowance for deferred-tax assets, that may be included in, that is, not deducted from, a bank's capital may not exceed the lesser of:

i. The amount of these deferred-tax assets that the bank is expected to realize within one year of the calendar quarter-end date, based on its projections of future taxable income for that year,[20] or

[14] Amounts of servicing assets, purchased credit card relationships, and credit-enhancing I/Os (both retained and purchased) in excess of these limitations, as well as all other identifiable intangible assets, including core deposit intangibles and favorable leaseholds, are to be deducted from a bank's core capital elements in determining tier 1 capital. However, identifiable intangible assets (other than mortgage servicing assets and purchased credit card relationships) acquired on or before February 19, 1992, generally will not be deducted from capital for supervisory purposes, although they will continue to be deducted for applications purposes.

[20] To determine the amount of expected deferred-tax assets realizable in the next 12 months, an institution should assume that all existing temporary differences fully reverse as of the report date. Projected future taxable income should not include net operating loss carry-forwards to be used during that year or the amount of existing temporary differences a bank expects to reverse within the year. Such projections should include

Continued

ii. 10 percent of tier 1 capital.

b. The reported amount of deferred-tax assets, net of any valuation allowance for deferred-tax assets, in excess of the lesser of these two amounts is to be deducted from a bank's core capital elements in determining tier 1 capital. For purposes of calculating the 10 percent limitation, tier 1 capital is defined as the sum of core capital elements, net of goodwill and net of all identifiable intangible assets other than mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships, prior to the deduction of any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed credit-enhancing I/Os, and any disallowed deferred-tax assets. There generally is no limit in tier 1 capital on the amount of deferred-tax assets that can be realized from taxes paid in prior carry-back years or from future reversals of existing taxable temporary differences, but, for banks that have a parent, this may not exceed the amount the bank could reasonably expect its parent to refund.

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III. * * *

A. * * *

The Federal Reserve will, on a case-by-case basis, determine the appropriate risk weight for any asset or credit equivalent amount of an off-balance sheet item that does not fit wholly within 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 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.

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B. * * *

3. *Recourse obligations, direct credit substitutes, residual interests, 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. The term ''asset securitizations'' or ''securitizations'' in this rule includes structured financings, as well as asset securitization transactions.

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

ii. *Credit-enhancing 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 the bank to protect investors from losses arising from credit risk in the assets transferred or the loans serviced. Credit-enhancing 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. Credit-enhancing representations and warranties do not include:

1. Early default clauses and similar warranties that permit the return of, or premium refund clauses covering, 1–4 family residential first mortgage loans that qualify for a 50 percent risk weight for a period not to exceed 120 days from the date of transfer. These warranties may cover only those loans that were originated within 1 year of the date of transfer;

2. Premium refund clauses that cover assets guaranteed, in whole or in part, by the U.S. Government, a U.S. Government agency or a government-sponsored enterprise, provided the premium refund clauses are for a period not to exceed 120 days from the date of transfer; or

3. Warranties that permit the return of assets in instances of misrepresentation, fraud or incomplete documentation.

iii. *Direct credit substitute* means an arrangement in which a bank *assumes*, in form or in substance, credit risk associated with an on-or off-balance sheet credit exposure that was not previously owned by the bank (third-party asset) and the risk assumed by the bank exceeds the *pro rata* share of the bank's interest in the third-party asset. If the bank has no claim on the third-party asset, then the bank's assumption of *any* credit risk with respect to the third party asset is a direct credit substitute. Direct credit substitutes include, but are not limited to:

1. Financial standby letters of credit that support financial claims on a third party that exceed a bank's *pro rata* share of losses in the financial claim;

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

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

4. Credit derivative contracts under which the bank assumes more than its *pro rata* share of credit risk on a third party exposure;

5. Loans or lines of credit that provide credit enhancement for the financial obligations of an account party;

6. Purchased loan servicing assets if the servicer is responsible for credit losses or if the servicer makes or assumes credit-enhancing representations and warranties with respect to the loans serviced. Mortgage servicer cash advances that meet the conditions of section III.B.3.a.viii. of this appendix are not direct credit substitutes; and

7. Clean-up calls on third party assets are direct credit substitutes. Clean-up calls that are 10 percent or less of the original pool balance that are exercisable at the option of the bank are not direct credit substitutes.

iv. *Externally rated* means that an 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. *Financial asset* means cash or other monetary instrument, evidence of debt, evidence of an ownership interest in an entity, or a contract that conveys a right to receive or exchange cash or another financial instrument from another party.

vii. *Financial standby letter of credit* means a letter of credit or similar arrangement that represents an irrevocable obligation to a third-party beneficiary:

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the estimated effect of tax-planning strategies that the organization expects to implement to realize net operating losses or tax-credit carry-forwards that would otherwise expire during the year. Institutions do not have to prepare a new 12-month projection each quarter. Rather, on interim report dates, institutions may use the future-taxable income projections for their current fiscal year, adjusted for any significant changes that have occurred or are expected to occur.

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

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

viii. *Mortgage servicer cash advance* means funds that a residential mortgage loan 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:

1. 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

2. For any one loan, the servicer's obligation to make nonreimbursable advances is contractually limited to an insignificant amount of the outstanding principal balance of that loan.

ix. *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.

x. *Recourse* means the retention, by a bank, in form or in substance, of any credit risk 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 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 the assets or 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:

1. Credit-enhancing representations and warranties made on the transferred assets;

2. Loan servicing assets retained pursuant to an agreement under which the bank will be responsible for credit losses associated with the loans being serviced. Mortgage servicer cash advances that meet the conditions of section III.B.3.a.viii. of this appendix are not recourse arrangements;

3. Retained subordinated interests 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;

5. Loan strips sold without contractual recourse where the maturity of the transferred loan is shorter than the maturity of the commitment under which the loan is drawn;

6. Credit derivatives issued that absorb more than the bank's *pro rata* share of losses from the transferred assets; and

7. Clean-up calls at inception that are greater than 10 percent of the balance of the original pool of transferred loans. Clean-up calls that are 10 percent or less of the original pool balance that are exercisable at the option of the bank are not recourse arrangements.

xi. *Residual interest* means any on-balance sheet asset that represents an interest (including a beneficial interest) created by a transfer that qualifies as a sale (in accordance with generally accepted accounting principles) of financial assets, whether through a securitization or otherwise, and that exposes the bank to credit risk directly or indirectly associated with the transferred assets that exceeds a *pro rata* share of the bank's claim on the assets, whether through subordination provisions or other credit enhancement techniques. Residual interests generally include credit-enhancing I/Os, spread accounts, cash collateral accounts, retained subordinated interests, other forms of over-collateralization, and similar assets that function as a credit enhancement. Residual interests further include those exposures that, in substance, cause the bank to retain the credit risk of an asset or exposure that had qualified as a residual interest before it was sold. Residual interests generally do not include interests purchased from a third party, except that purchased credit-enhancing I/Os are residual interests for purposes of this appendix.

xii. *Risk participation* means a participation in which the originating party 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.

xiii. *Securitization* means the pooling and repackaging by a special purpose entity of assets or other credit exposures into securities that can be sold to investors. Securitization includes transactions that create stratified credit risk positions whose performance is dependent upon an underlying pool of credit exposures, including loans and commitments.

xiv. *Structured finance program* means 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. Structured finance programs allocate credit risks, generally, between the participants and credit enhancement provided to the program.

xv. *Traded position* means a position that is externally rated and is retained, assumed, or issued in connection with an asset securitization, where there is a reasonable expectation that, in the near future, the rating will be relied upon by unaffiliated investors to purchase the position; or an unaffiliated third party to enter into a transaction involving the position, such as a purchase, loan, or repurchase agreement.

b. *Credit equivalent amounts and risk weight of recourse obligations and direct credit substitutes.* i. *Credit equivalent amount.* Except as otherwise provided in sections III.B.3.c. through f. and III.B.5. of this appendix, 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 percent conversion factor.

ii. *Risk-weight factor.* To determine the bank's risk-weight factor 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. 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.

c. *Externally-rated positions: credit equivalent amounts and risk weights of recourse obligations, direct credit substitutes, residual interests, and asset- and mortgage-backed securities (including asset-backed commercial paper).* i. *Traded positions.* With respect to a recourse obligation, direct credit substitute, residual interest (other than a credit-enhancing I/O strip) or asset-

and mortgage-backed security (including asset-backed commercial paper) that is a traded position and that has received an external rating on a long-term position that is one grade below investment grade or better or a short-term rating that is investment grade, the bank may multiply the face amount of the position by the appropriate risk weight, determined in accordance with the tables below. Stripped mortgage-backed securities and other similar instruments, such as interest-only or principal-only strips that are not credit enhancements, must be assigned to the 100 percent risk category. If a traded position has received more than one external rating, the lowest single rating will apply.

Long-term rating category	Examples	Risk weight (In 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

Short-term rating	Examples	Risk weight (In percent)
Highest investment grade	A–1, P–1	20
Second highest investment grade	A–2, P–2	50
Lowest investment grade	A–3, P–3	100

ii. *Non-traded positions.* A recourse obligation, direct credit substitute, or residual interest (but not a credit-enhancing I/O strip) extended in connection with a securitization that is not a traded position may be assigned a risk weight in accordance with section III.B.3.c.i. of this appendix if:

1. It has been externally rated by more than one NRSRO;

2. It has received an external rating on a long-term position that is one grade below investment grade or better or on a short-term position that is investment grade by all NRSROs providing a rating;

3. The ratings are publicly available; and

4. The ratings are based on the same criteria used to rate traded positions.

If the ratings are different, the lowest rating will determine the risk category to which the recourse obligation, direct credit substitute, or residual interest will be assigned.

d. *Senior positions not externally rated.* For a recourse obligation, direct credit substitute, residual interest, or asset- or mortgage-backed security that is not externally rated but is senior or preferred in all features to a traded position (including collateralization and maturity), a bank may apply a risk weight to the face amount of the senior position in accordance with section III.B.3.c.i. of this appendix, based on the traded position, subject to any current or prospective supervisory guidance and the bank satisfying the Federal Reserve that this treatment is appropriate. This section will apply only if the traded subordinated position provides substantive credit support to the unrated position until the unrated position matures.

e. *Capital requirement for residual interests*—i. *Capital requirement for credit-enhancing I/O strips.* After applying the concentration limit to credit-enhancing I/O strips (both purchased and retained) in accordance with sections II.B.2.c. through e. of this appendix, a bank must maintain risk-based capital for a credit-enhancing I/O strip (both purchased and retained), regardless of the external rating on that position, equal to the remaining amount of the credit-enhancing I/O strip (net of any existing associated deferred tax liability), even if the amount of risk-based capital required to be maintained exceeds the full risk-based capital requirement for the assets transferred. Transactions that, in substance, result in the retention of credit risk associated with a transferred credit-enhancing I/O strip will be treated as if the credit-enhancing I/O strip was retained by the bank and not transferred.

ii. *Capital requirement for other residual interests. 1.* If a residual interest does not meet the requirements of sections III.B.3.c. or d. of this appendix, a bank must maintain risk-based capital equal to the remaining amount of the residual interest that is retained on the balance sheet (net of any existing associated deferred tax liability), even if the amount of risk-based capital required to be maintained exceeds the full risk-based capital requirement for the assets transferred. Transactions that, in substance, result in the retention of credit risk associated with a transferred residual interest will be treated as if the residual interest was retained by the bank and not transferred.

2. Where the aggregate capital requirement for residual interests and other recourse obligation in connection with the same transfer of assets exceed the full risk-based capital requirement for those assets, a bank must maintain risk-based capital equal to the greater of the risk-based capital requirement for the residual interest as calculated under section III.B.3.e.ii.*1* of this appendix or the full risk-based capital requirement for the assets transferred.

f. *Positions that are not rated by an NRSRO.* A position (but not a residual interest) maintained in connection with a securitization and that is not rated by a NRSRO may be risk-weighted based on the bank's determination of the credit rating of the position, as specified in the table below, multiplied by the face amount of the position. In order to obtain this treatment, the bank's system for determining the credit rating of the position must meet one of the three alternative standards set out in sections III.B.3.f.i. through III.B.3.f.iii. of this appendix.

Rating category	Examples	Risk weight (In percent)
Highest or second highest investment grade	AAA,AA	100
Third highet 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.* A direct credit substitute (other than a purchased credit-enhancing I/O) is assumed in connection with an asset-backed commercial paper program sponsored by the bank and the bank is able to demonstrate to the satisfaction of the Federal Reserve, prior to relying upon its use, that the bank's internal credit risk rating system is adequate. Adequate internal credit risk rating systems usually contain the following criteria:

1. The internal credit risk system is an integral part of the bank's risk management system, which explicitly incorporates the full range of risks arising from a bank's participation in securitization activities;

2. 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;

3. 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;

4. The bank's internal credit risk system must identify gradations of risk among ''pass'' assets and other risk positions;

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

6. The bank must have independent credit risk management or loan review personnel assigning or reviewing the credit risk ratings;

7. The bank must have an internal audit procedure that periodically verifies that the internal credit risk ratings are assigned in accordance with the established criteria;

8. 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

9. 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.* A direct credit substitute or recourse obligation (other than a residual interest) is assumed or retained in connection with a structured finance program and a NRSRO has reviewed the terms of the program 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 specifies ranges of rating categories to them, the bank may apply the rating category that corresponds to the bank's position. In order to rely on a program rating, the bank must demonstrate to the Federal Reserve's satisfaction that the credit risk rating assigned to the program meets the same standards generally used by NRSROs for rating traded positions. The bank must also demonstrate to the Federal Reserve's satisfaction that the criteria underlying the NRSRO's assignment of ratings for the program are satisfied for the particular position. If a bank participates in a securitization 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.

iii. *Computer Program.* The bank is using an acceptable credit assessment computer program to determine the rating of a direct credit substitute or recourse obligation (but not residual interest) issued in connection with a structured finance program. A NRSRO must have developed the computer program, and the bank must demonstrate to the Federal Reserve's satisfaction that ratings under the program correspond credibly and reliably with the rating of traded positions.

g. *Limitations on risk-based capital requirements*—i. *Low-level exposure.* If the maximum contractual 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 exposure, less any recourse liability account established in accordance with generally accepted accounting principles. This limitation does not apply when a bank provides credit enhancement beyond any contractual obligation to support assets it has sold.

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 on-balance sheet assets.

iii. *Related on-balance sheet assets.* If a recourse obligation or direct credit substitute subject to section III.B.3. of this appendix 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 that case, both the on-balance sheet assets and the related recourse obligations and direct credit substitutes must be separately risk-weighted and 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,

[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 the bank.

[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-

Continued

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 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 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. 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 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, 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.

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]

* * * * *

term claims guaranteed by U.S. depository institutions and foreign banks.

[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.

ATTACHMENT II.—SUMMARY OF DEFINITION OF QUALIFYING CAPITAL FOR STATE MEMBER BANKS*

[Using the year-end 1992 standard]

Components	Minimum requirements
Core Capital (Tier 1)	Must equal or exceed 4% of weighted-risk assets.
Common stockholders' equity	No limit.
Qualifying noncumulative perpetual preferred stock	No limit; banks should avoid undue reliance on preferred stock in tier 1.
Minority interest in equity accounts of consolidated subsidiaries	Banks should avoid using minority interests to subsidiaries introduce elements not otherwise qualifying for tier 1 capital.
Less: Goodwill, other intangible assets, and credit-enhancing interest-only strips required to be deducted from capital [1]	
Supplementary Capital (Tier 2)	Total of tier 2 is limited to 100% of tier 1.[2]
Allowance for loan and lease losses	Limited to 1.25% of weighted-risk assets.[2]
Perpetual preferred stock	No limit within tier 2.
Hybrid capital instruments and equity contract notes	No limit within tier 2.
Subordinated debt and intermediate-term preferred stocks (original weighted average maturity of 5 years or more).	Subordinated debt and intermediate-term preferred stock are limited to 50% of tier 1,[2] amortized for capital purposes as they approach maturity.
Revaluation reserves (equity and building)	Not included; banks encouraged to disclose; may be evaluated on a case-by-case basis for international comparisons; and taken into account in making an overall assessment of capital.
Deductions (from sum of tier 1 and tier 2):	
Investment in unconsolidated subsidiaries	As a general rule, one-half of the aggregate investments will be deducted from tier 1 capital and one-half from tier 2 capital.[3]
Reciprocal holdings of banking organizations' capital securities	
Other deductions (such as other subsidiaries or joint ventures) as determined by supervisory authority.	On a case-by-case basis or as a matter of policy after a formal rulemaking.
Total Capital (tier 1 + tier 2— deductions)	Must equal or exceed 8% or weighted-risk assets.

[1] Requirements for the deduction of other intangible assets and residual interests are set forth in section II.B.1. of this appendix.
[2] Amount in excess of limitations are permitted but do not qualify as capital.
[3] A proportionately greater amount may be deducted from tier 1 capital, if the risks associated with the subsidiary so warrant.
* See discussion in section II of the guidelines for a complete description of the requirements for, and the limitations on, the components of qualifying capital.

* * * * *

3. In Appendix B to part 208, section II.b is revised to read as follows:

Appendix B To Part 208—Capital Adequacy Guidelines for State Member Banks: Tier 1 Leverage Measure

* * * * *

II. * * *

b. A bank's tier 1 leverage ratio is calculated by dividing its tier 1 capital (the numerator of the ratio) by its average total consolidated assets (the denominator of the ratio). The ratio will also be calculated using period-end assets whenever necessary, on a case-by-case basis. For the purpose of this leverage ratio, the definition of tier 1 capital as set forth in the risk-based capital guidelines contained in appendix A of this part will be used.[2] As a general matter, average total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the bank's Reports of Condition and Income (Call Reports), less goodwill; amounts of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that, in the aggregate, are in excess of 100 percent of tier 1 capital; amounts of nonmortgage servicing assets, purchased credit card relationships that, in the aggregate, are in excess of 25 percent of tier 1 capital; amounts of credit-enhancing interest-only strips that are in excess of 25 percent of tier 1 capital; all other identifiable intangible assets; any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from tier 1 capital; and deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of the limitation set forth in section II.B.4 of appendix A of this part.[3]

* * * * *

[2] Tier 1 capital for state member banks includes common equity, minority interest in the equity accounts of consolidated subsidiaries, and qualifying noncumulative perpetual preferred stock. In addition, as a general matter, tier 1 capital excludes goodwill; amounts of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that, in the aggregate, exceed 100 percent of tier 1 capital; amounts of nonmortgage servicing assets and purchased credit card relationships that, in the aggregate, exceed 25 percent of tier 1 capital; amounts of credit-enhancing interest-only strips in excess of 25 percent of tier 1 capital; all other identifiable intangible assets; and deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of certain limitations. The Federal Reserve may exclude certain investments in subsidiaries or associated companies as appropriate.

[3] Deductions from tier 1 capital and other adjustments are discussed more fully in section II.B. of appendix A of this part.

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), 1843(k), 1844(b), 1972(1), 3106, 3108, 3310, 3331–3351, 3907, and 3909.

2. In appendix A to part 225:

A. The three introductory paragraphs of section II, the first six paragraphs of section II.A.1, and the first seven paragraphs of section II.A.2. are revised and footnote 6 is removed and reserved;

B. In section II.B., a new paragraph (i)(c) is added, section II.B.1.b. and footnote 15 are revised, new sections II.B.1.c. through II.B.1.g. are added, and section II.B.4. is revised;

C. In section III.A., a new undesignated fourth paragraph is added at the end of the section;

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

E. In section III.C., paragraphs 1 through 4, footnotes 28 through 42 are redesignated as footnotes 26 through 40, and paragraph 4 is revised;

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

G. In sections III.D. and III.E., footnotes 50 and 52 are removed, footnote 51 is redesignated as footnote 47, footnotes 53 through 55 are redesignated as footnotes 48 through 50;

H. In sections IV.A. and IV.B., footnote 57 is removed and footnote 56 is redesignated as footnote 51; and

I. Attachment II is revised.

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

* * * * *

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 instrument 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 instrument to instruments explicitly treated in the guidelines, the ability of the instrument to absorb losses while the institution operates as a going concern, the maturity and redemption features of the instrument, 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]

* * * * *

A. * * *

1. *Core capital elements (tier 1 capital).* The tier 1 component of an institution's qualifying capital must represent at least 50 percent of qualifying total capital and may consist of the following items that are defined as core capital elements:

(i) Common stockholders' equity;

(ii) Qualifying noncumulative perpetual preferred stock (including related surplus);

(iii) Qualifying cumulative perpetual preferred stock (including related surplus), subject to certain limitations described below; and

(iv) Minority interest in the equity accounts of consolidated subsidiaries.

Tier 1 capital is generally defined as the sum of core capital elements[6] less goodwill, other intangible assets, and interest-only strips receivables that are required to be deducted in accordance with section II.B.1. of this appendix.

* * * * *

2. *Supplementary capital elements (tier 2 capital).* The tier 2 component of an institution's qualifying capital may consist of the following items that are defined as supplementary capital elements:

(i) Allowance for loan and lease losses (subject to limitations discussed below);

(ii) Perpetual preferred stock and related surplus (subject to conditions discussed below);

(iii) Hybrid capital instruments (as defined below), perpetual debt, and mandatory convertible debt securities;

(iv) Term subordinated debt and intermediate-term preferred stock, including related surplus (subject to limitations discussed below);

(v) Unrealized holding gains on equity securities (subject to limitations discussed in section II.A.2.e. of this appendix).

The maximum amount of tier 2 capital that may be included in an institution's qualifying total capital is limited to 100 percent of tier 1 capital (net of goodwill, other intangible assets, and interest-only strips receivables that are required to be deducted in accordance with section II.B.1. of this appendix).

* * * * *

B. * * *

(i) * * *

(c) Certain credit-enhancing interest-only strips receivables—deducted from the sum of core capital elements in accordance with sections II.B.1.c. through e. of this appendix.

* * * * *

1. *Goodwill, other intangible assets, and residual interests.* * * *

b. *Other intangible assets.* i. All servicing assets, including servicing assets on assets other than mortgages (i.e., nonmortgage servicing assets), are included in this appendix as identifiable intangible assets. The only types of identifiable intangible assets that may be included in, that is, not deducted from, an organization's capital are readily marketable mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships. The total amount of these assets that may be included in capital is subject to the limitations described below in sections II.B.1.d. and e. of this appendix.

ii. The treatment of identifiable intangible assets set forth in this section generally will be used in the calculation of a bank holding company's capital ratios for supervisory and applications purposes. However, in making an overall assessment of a bank holding company's capital adequacy for applications purposes, the Board may, if it deems appropriate, take into account the quality and composition of an organization's capital, together with the quality and value of its tangible and intangible assets.

c. *Credit-enhancing interest-only strips receivables (I/Os)* i. Credit-enhancing I/Os are on-balance sheet assets that, in form or in substance, represent a contractual right to receive some or all of the interest due on transferred assets and expose the bank holding company to credit risk directly or indirectly associated with transferred assets that exceeds a *pro rata* share of the bank holding company's claim on the assets, whether through subordination provisions or other credit enhancement techniques. Such I/Os, whether purchased or retained, including other similar ''spread'' assets, may be included in, that is, not deducted from, a bank holding company's capital subject to the limitations described below in sections II.B.1.d. and e. of this appendix.

ii. Both purchased and retained credit-enhancing I/Os, on a non-tax adjusted basis, are included in the total

[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.

[6] [Reserved]

amount that is used for purposes of determining whether a bank holding company exceeds the tier 1 limitation described below in this section. In determining whether an I/O or other types of spread assets serve as a credit enhancement, the Federal Reserve will look to the economic substance of the transaction.

d. *Fair value limitation.* The amount of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that a bank holding company may include in capital shall be the lesser of 90 percent of their fair value, as determined in accordance with section II.B.1.f. of this appendix, or 100 percent of their book value, as adjusted for capital purposes in accordance with the instructions to the Consolidated Financial Statements for Bank Holding Companies (FR Y–9C Report). The amount of credit-enhancing I/Os that a bank holding company may include in capital shall be its fair value. If both the application of the limits on mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships and the adjustment of the balance sheet amount for these assets would result in an amount being deducted from capital, the bank holding company would deduct only the greater of the two amounts from its core capital elements in determining tier 1 capital.

e. *Tier 1 capital limitation.* i. The total amount of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that may be included in capital, in the aggregate, cannot exceed 100 percent of tier 1 capital. Nonmortgage servicing assets and purchased credit card relationships are subject, in the aggregate, to a separate sublimit of 25 percent of tier 1 capital. In addition, the total amount of credit-enhancing I/Os (both purchased and retained) that may be included in capital cannot exceed 25 percent of tier 1 capital.[15]

ii. For purposes of calculating these limitations on mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships, and credit-enhancing I/Os, tier 1 capital is defined as the sum of core capital elements, net of goodwill, and net of all identifiable intangible assets other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships, prior to the deduction of any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed credit-enhancing I/Os (both purchased and retained), and any disallowed deferred-tax assets, regardless of the date acquired.

iii. Bank holding companies may elect to deduct disallowed mortgage servicing assets, disallowed nonmortgage servicing assets, and disallowed credit-enhancing I/Os (both purchased and retained) on a basis that is net of any associated deferred tax liability. Deferred tax liabilities netted in this manner cannot also be netted against deferred-tax assets when determining the amount of deferred-tax assets that are dependent upon future taxable income.

f. *Valuation.* Bank holding companies must review the book value of all intangible assets at least quarterly and make adjustments to these values as necessary. The fair value of mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships, and credit-enhancing I/Os also must be determined at least quarterly. This determination shall include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates or account attrition rates. Examiners will review both the book value and the fair value assigned to these assets, together with supporting documentation, during the inspection process. In addition, the Federal Reserve may require, on a case-by-case basis, an independent valuation of a bank holding company's intangible assets or credit-enhancing I/Os.

g. *Growing organizations.* Consistent with long-standing Board policy, banking organizations experiencing substantial growth, whether internally or by acquisition, are expected to maintain strong capital positions substantially above minimum supervisory levels, without significant reliance on intangible assets or credit-enhancing I/Os.

4. *Deferred-tax assets.* a. The amount of deferred-tax assets that is dependent upon future taxable income, net of the valuation allowance for deferred-tax assets, that may be included in, that is, not deducted from, a bank holding company's capital may not exceed the lesser of:

i. The amount of these deferred-tax assets that the bank holding company is expected to realize within one year of the calendar quarter-end date, based on its projections of future taxable income for that year,[23] or

ii. 10 percent of tier 1 capital.

b. The reported amount of deferred-tax assets, net of any valuation allowance for deferred-tax assets, in excess of the lesser of these two amounts is to be deducted from a banking organization's core capital elements in determining tier 1 capital. For purposes of calculating the 10 percent limitation, tier 1 capital is defined as the sum of core capital elements, net of goodwill and net of all identifiable intangible assets other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships, prior to the deduction of any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed credit-enhancing I/Os, and any disallowed deferred-tax assets. There generally is no limit in tier 1 capital on the amount of deferred-tax assets that can be realized from taxes paid in prior carry-back years or from future reversals of existing taxable temporary differences.

* * * * *

III. * * *

A. * * *

The Federal Reserve will, on a case-by-case basis, determine the appropriate risk weight for any asset or 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 holding company 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

[15] Amounts of servicing assets, purchased credit card relationships, and credit-enhancing I/Os (both retained and purchased) in excess of these limitations, as well as all other identifiable intangible assets, including core deposit intangibles and favorable leaseholds, are to be deducted from a bank holding company's core capital elements in determining tier 1 capital. However, identifiable intangible assets (other than mortgage servicing assets and purchased credit card relationships) acquired on or before February 19, 1992, generally will not be deducted from capital for supervisory purposes, although they will continue to be deducted for applications purposes.

[23] To determine the amount of expected deferred-tax assets realizable in the next 12 months, an institution should assume that all existing temporary differences fully reverse as of the report date. Projected future taxable income should not include net operating loss carry-forwards to be used during that year or the amount of existing temporary differences a bank holding company expects to reverse within the year. Such projections should include the estimated effect of tax-planning strategies that the organization expects to implement to realize net operating losses or tax-credit carry-forwards that would otherwise expire during the year. Institutions do not have to prepare a new 12-month projection each quarter. Rather, on interim report dates, institutions may use the future-taxable income projections for their current fiscal year, adjusted for any significant changes that have occurred or are expected to occur.

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 banking organization 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, residual interests, 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. The term ''asset securitizations'' or ''securitizations'' in this rule includes structured financings, as well as asset securitization transactions.

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

ii. *Credit-enhancing 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 the bank holding company to protect investors from losses arising from credit risk in the assets transferred or the loans serviced. Credit-enhancing 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. Credit-enhancing representations and warranties do not include:

1. Early default clauses and similar warranties that permit the return of, or premium refund clauses covering, 1–4 family residential first mortgage loans that qualify for a 50 percent risk weight for a period not to exceed 120 days from the date of transfer. These warranties may cover only those loans that were originated within 1 year of the date of transfer;

2. Premium refund clauses that cover assets guaranteed, in whole or in part, by the U.S. Government, a U.S. Government agency or a government-sponsored enterprise, provided the premium refund clauses are for a period not to exceed 120 days from the date of transfer; or

3. Warranties that permit the return of assets in instances of misrepresentation, fraud or incomplete documentation.

iii. *Direct credit substitute* means an arrangement in which a bank holding company *assumes,* in form or in substance, credit risk associated with an on- or off-balance sheet credit exposure that was not previously owned by the bank holding company (third-party asset) and the risk assumed by the bank holding company exceeds the *pro rata* share of the bank holding company's interest in the third-party asset. If the bank holding company has no claim on the third-party asset, then the bank holding company's assumption of *any* credit risk with respect to the third-party asset is a direct credit substitute. Direct credit substitutes include, but are not limited to:

1. Financial standby letters of credit that support financial claims on a third party that exceed a bank holding company's *pro rata* share of losses in the financial claim;

2. Guarantees, surety arrangements, credit derivatives, and similar instruments backing financial claims that exceed a bank holding company's *pro rata* share in the financial claim;

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

4. Credit derivative contracts under which the bank holding company assumes more than its *pro rata* share of credit risk on a third party exposure;

5. Loans or lines of credit that provide credit enhancement for the financial obligations of an account party;

6. Purchased loan servicing assets if the servicer is responsible for credit losses or if the servicer makes or assumes credit-enhancing representations and warranties with respect to the loans serviced. Mortgage servicer cash advances that meet the conditions of section III.B.3.a.viii. of this appendix are not direct credit substitutes; and

7. Clean-up calls on third party assets are direct credit substitutes. Clean-up calls that are 10 percent or less of the original pool balance that are exercisable at the option of the bank holding company are not direct credit substitutes.

iv. *Externally rated* means that an 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. *Financial asset* means cash or other monetary instrument, evidence of debt, evidence of an ownership interest in an entity, or a contract that conveys a right to receive or exchange cash or another financial instrument from another party.

vii. *Financial standby letter of credit* means a letter of credit or similar arrangement that represents an irrevocable obligation to a third-party beneficiary:

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

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

viii. *Mortgage servicer cash advance* means funds that a residential mortgage loan 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:

1. 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

2. For any one loan, the servicer's obligation to make nonreimbursable advances is contractually limited to an insignificant amount of the outstanding principal balance of that loan.

ix. *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.

x. *Recourse* means the retention, by a bank holding company, in form or in substance, of any credit risk directly or indirectly associated with an asset it has transferred and sold 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 credit loss is recourse. A recourse obligation typically arises when a bank holding company transfers assets and retains an explicit obligation

to repurchase the assets or 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 holding company provides credit enhancement beyond any contractual obligation to support assets it has sold. The following are examples of recourse arrangements:

1. Credit-enhancing representations and warranties made on the transferred assets;

2. Loan servicing assets retained pursuant to an agreement under which the bank holding company will be responsible for credit losses associated with the loans being serviced. Mortgage servicer cash advances that meet the conditions of section III.B.3.a.viii. of this appendix are not recourse arrangements;

3. Retained subordinated interests 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;

5. Loan strips sold without contractual recourse where the maturity of the transferred loan is shorter than the maturity of the commitment under which the loan is drawn;

6. Credit derivatives issued that absorb more than the bank holding company's *pro rata* share of losses from the transferred assets; and

7. Clean-up calls at inception that are greater than 10 percent of the balance of the original pool of transferred loans. Clean-up calls that are 10 percent or less of the original pool balance that are exercisable at the option of the bank holding company are not recourse arrangements.

xi. *Residual interest* means any on-balance sheet asset that represents an interest (including a beneficial interest) created by a transfer that qualifies as a sale (in accordance with generally accepted accounting principles) of financial assets, whether through a securitization or otherwise, and that exposes the bank holding company to credit risk directly or indirectly associated with the transferred assets that exceeds a *pro rata* share of the bank holding company's claim on the assets, whether through subordination provisions or other credit enhancement techniques. Residual interests generally include credit-enhancing I/Os, spread accounts, cash collateral accounts, retained subordinated interests, other forms of over-collateralization, and similar assets that function as a credit enhancement. Residual interests further include those exposures that, in substance, cause the bank holding company to retain the credit risk of an asset or exposure that had qualified as a residual interest before it was sold. Residual interests generally do not include interests purchased from a third party, except that purchased credit-enhancing I/Os are residual interests for purposes of this appendix.

xii. *Risk participation* means a participation in which the originating party 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.

xiii. *Securitization* means the pooling and repackaging by a special purpose entity of assets or other credit exposures into securities that can be sold to investors. Securitization includes transactions that create stratified credit risk positions whose performance is dependent upon an underlying pool of credit exposures, including loans and commitments.

xiv. *Structured finance program* means 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. Structured finance programs allocate credit risks, generally, between the participants and credit enhancement provided to the program.

xv. *Traded position* means a position that is externally rated, and is retained, assumed, or issued in connection with an asset securitization, where there is a reasonable expectation that, in the near future, the rating will be relied upon by unaffiliated investors to purchase the position; or an unaffiliated third party to enter into a transaction involving the position, such as a purchase, loan, or repurchase agreement.

b. *Credit equivalent amounts and risk weight of recourse obligations and direct credit substitutes.* i. *Credit equivalent amount.* Except as otherwise provided in sections III.B.3.c. through f. and III.B.5. of this appendix, 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 holding company directly or indirectly retains or assumes credit risk multiplied by a 100 percent conversion factor.

ii. *Risk-weight factor.* To determine the bank holding company's risk-weight factor 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 holding company 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. 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.

c. *Externally-rated positions: credit-equivalent amounts and risk weights of recourse obligations, direct credit substitutes, residual interests, and asset- and mortgage-backed securities (including asset-backed commercial paper)*—i. *Traded positions.* With respect to a recourse obligation, direct credit substitute, residual interest (other than a credit-enhancing I/Ostrip) or asset- and mortgage-backed security (including asset-backed commercial paper) that is a traded position and that has received an external rating on a long-term position that is one grade below investment grade or better or a short-term rating that is investment grade, the bank holding company may multiply the face amount of the position by the appropriate risk weight, determined in accordance with the tables below. Stripped mortgage-backed securities and other similar instruments, such as interest-only or principal-only strips that are not credit enhancements, must be assigned to the 100 percent risk category. If a traded position has received more than one external rating, the lowest single rating will apply.

Long-term rating category	Examples	Risk weight (In 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

Short-term rating	Examples	Risk weight (In percent)
Highest investment grade	A–1, P–1	20
Second highest investment grade	A–2, P–2	50
Lowest investment grade	A–3, P–3	100

ii. *Non-traded positions.* A recourse obligation, direct credit substitute, or residual interest (but not a credit-enhancing I/O strip) extended in connection with a securitization that is not a traded position may be assigned a risk weight in accordance with section III.B.3.c.i. of this appendix if:

1. It has been externally rated by more than one NRSRO;

2. It has received an external rating on a long-term position that is one grade below investment grade or better or on a short-term position that is investment grade by all NRSROs providing a rating;

3. The ratings are publicly available; and

4. The ratings are based on the same criteria used to rate traded positions.

If the ratings are different, the lowest rating will determine the risk category to which the recourse obligation, direct credit substitute, or residual interest will be assigned.

d. *Senior positions not externally rated.* For a recourse obligation, direct credit substitute, residual interest, or asset-or mortgage-backed security that is not externally rated but is senior or preferred in all features to a traded position (including collateralization and maturity), a bank holding company may apply a risk weight to the face amount of the senior position in accordance with section III.B.3.c.i. of this appendix, based on the traded position, subject to any current or prospective supervisory guidance and the bank holding company satisfying the Federal Reserve that this treatment is appropriate. This section will apply only if the traded subordinated position provides substantive credit support to the unrated position until the unrated position matures.

e. *Capital requirement for residual interests*—i. *Capital requirement for credit-enhancing I/O strips.* After applying the concentration limit to credit-enhancing I/O strips (both purchased and retained) in accordance with sections II.B.2.c. through e. of this appendix, a bank holding company must maintain risk-based capital for a credit-enhancing I/O strip (both purchased and retained), regardless of the external rating on that position, equal to the remaining amount of the credit-enhancing I/O (net of any existing associated deferred tax liability), even if the amount of risk-based capital required to be maintained exceeds the full risk-based capital requirement for the assets transferred. Transactions that, in substance, result in the retention of credit risk associated with a transferred credit-enhancing I/O strip will be treated as if the credit-enhancing I/O strip was retained by the bank holding company and not transferred.

ii. *Capital requirement for other residual interests. 1.* If a residual interest does not meet the requirements of sections III.B.3.c. or d. of this appendix, a bank holding must maintain risk-based capital equal to the remaining amount of the residual interest that is retained on the balance sheet (net of any existing associated deferred tax liability), even if the amount of risk-based capital required to be maintained exceeds the full risk-based capital requirement for the assets transferred. Transactions that, in substance, result in the retention of credit risk associated with a transferred residual interest will be treated as if the residual interest was retained by the bank holding company and not transferred.

2. Where the aggregate capital requirement for residual interests and other recourse obligations in connection with the same transfer of assets exceed the full risk-based capital requirement for those assets, a bank holding company must maintain risk-based capital equal to the greater of the risk-based capital requirement for the residual interest as calculated under section III.B.3.e.ii.*1.* of this appendix or the full risk-based capital requirement for the assets transferred.

f. *Positions that are not rated by an NRSRO.* A position (but not a residual interest) maintained in connection with a securitization and that is not rated by a NRSRO may be risk-weighted based on the bank holding company's determination of the credit rating of the position, as specified in the table below, multiplied by the face amount of the position. In order to obtain this treatment, the bank holding company's system for determining the credit rating of the position must meet one of the three alternative standards set out in sections III.B.3.f.i. through III.B.3.f.iii. of this appendix.

Rating category	Examples	Risk weight (In 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.* A direct credit substitute (other than a purchased credit-enhancing I/O) is assumed in connection with an asset-backed commercial paper program sponsored by the bank holding company and the bank holding company is able to demonstrate to the satisfaction of the Federal Reserve, prior to relying upon its use, that the bank holding company's internal credit risk rating system is adequate. Adequate internal credit risk rating systems usually contain the following criteria:

1. The internal credit risk system is an integral part of the bank holding company's risk management system, which explicitly incorporates the full range of risks arising from a bank holding company's participation in securitization activities;

2. 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;

3. The bank holding company'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;

4. The bank holding company's internal credit risk system must identify gradations of risk among ''pass'' assets and other risk positions;

5. The bank holding company must have clear, explicit criteria that are used to classify assets into each internal risk grade, including subjective factors;

6. The bank holding company must have independent credit risk management or loan review personnel assigning or reviewing the credit risk ratings;

7. The bank holding company must have an internal audit procedure that periodically verifies that the internal credit risk ratings are assigned in accordance with the established criteria;

8. The bank holding company 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

9. 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.* A direct credit substitute or recourse obligation (other than a residual interest) is assumed or retained in connection with a structured finance program and a NRSRO has reviewed the terms of the program 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 specifies ranges of rating categories to them, the bank holding company may apply the rating category that corresponds to the bank holding company's position. In order to rely on a program rating, the bank holding company must demonstrate to the Federal Reserve's satisfaction that the credit risk rating assigned to the program meets the same standards generally used by NRSROs for rating traded positions. The bank holding company must also demonstrate to the Federal Reserve's satisfaction that the criteria underlying the NRSRO's assignment of ratings for the program are satisfied for the particular position. If a bank holding company participates in a securitization sponsored by another party, the Federal Reserve may authorize the bank holding company to use this approach based on a programmatic rating obtained by the sponsor of the program.

iii. *Computer Program.* The bank holding company is using an acceptable credit assessment computer program to determine the rating of a direct credit substitute or recourse obligation (but not residual interest) issued in connection with a structured finance program. A NRSRO must have developed the computer program, and the bank holding company must demonstrate to the Federal Reserve's satisfaction that ratings under the program correspond credibly and reliably with the rating of traded positions.

g. *Limitations on risk-based capital requirements*—i. *Low-level exposure.* If the maximum contractual exposure to loss retained or assumed by a bank holding company 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 exposure, less any liability account established in accordance with generally accepted accounting principles. This limitation does not apply when a bank holding company provides credit enhancement beyond any contractual obligation to support assets it has sold.

ii. *Mortgage-related securities or participation certificates retained in a mortgage loan swap.* If a bank holding company 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 organization continued to hold these loans as on-balance sheet assets.

iii. *Related on-balance sheet assets.* If a recourse obligation or direct credit substitute subject to section III.B.3. of this appendix also appears as a balance sheet asset, the balance sheet asset is not included in an 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 that case, 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 organization 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 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 all obligations of states or political subdivisions of countries that do not belong to the OECD-based group.

[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.

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. 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, 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.

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 organization, or the independent custodian acting on the lending 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 a subsidiary depository institution 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 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]

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ATTACHMENT II.—SUMMARY OF DEFINITION OF QUALIFYING CAPITAL FOR BANK HOLDING COMPANIES*

[Using the year-end 1992 standard]

Components	Minimum requirements
Core Capital (Tier 1)	Must equal or exceed 4% of weighted-risk assets.
Common stockholders' equity	No limit.
Qualifying noncumulative perpetual preferred stock	No limit; banks should avoid undue reliance on preferred stock in tier 1.

[41] 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.

[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.

[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.

ATTACHMENT II.—SUMMARY OF DEFINITION OF QUALIFYING CAPITAL FOR BANK HOLDING COMPANIES*—Continued

[Using the year-end 1992 standard]

Components	Minimum requirements
Qualifying cumulative preferred stock	Limited to 25% of the sum of common stock, qualifying perpetual preferred stock, and minority interests.
Minority interest in equity accounts of consolidated subsidiaries.	Banks should avoid using minority interests to subsidiaries introduce elements not otherwise qualifying for tier 1 capital.
Less: Goodwill, other intangible assets, and credit-enhancing interest-only strips required to be deducted from capital[1]	
Supplementary Capital (Tier 2)	Total of tier 2 is limited to 100% of tier 1.[2]
Allowance for loan and lease losses	Limited to 1.25% of weighted-risk assets.[2]
Perpetual preferred stock	No limit within tier 2.
Hybrid instruments, perpetual debt and mandatory convertible securities..	No limit within tier 2.
Subordinated debt and intermediate-term preferred stock (original weighted average maturity of 5 years or more).	Subordinated debt and intermediate-term preferred stock are limited to 50% of tier 1,[2] amortized for capital purposes as they approach maturity.
Revaluation reserves (equity and building)	Not included; banks encouraged to disclose; may be evaluated on a case-by-case basis for international comparisons; and taken into account in making an overall assessment of capital.
Deductions (from sum of tier 1 and tier 2):	
Investment in unconsolidated subsidiaries	As a general rule, one-half of the aggregate investments will be deducted from tier 1 capital and one-half from tier 2 capital.[3]
Reciprocal holdings of banking organizations' capital securities.	
Other deductions (such as other subsidiaries or joint ventures) as determined by supervisory authority.	On a case-by-case basis or as a matter of policy after a formal rulemaking.
Total Capital (tier 1 + tier 2 − deductions)	Must equal or exceed 8% or weighted-risk assets.

[1] Requirements for the deduction of other intangible assets and residual interests are set forth in section II.B.1. of this appendix.

[2] Amount in excess of limitations are permitted but do not qualify as capital.

[3] A proportionately greater amount may be deducted from tier 1 capital, if the risks associated with the subsidiary so warrant.

* See discussion in section II of the guidelines for a complete description of the requirements for, and the limitations on, the components for qualifying capital.

* * * * *

3. In Appendix D to part 225, section II.b. is revised to read as follows:

Appendix D to Part 225—Capital Adequacy Guidelines for Bank Holding Companies: Tier 1 Leverage Measure

* * * * *

II. * * *

b. A banking organization's tier 1 leverage ratio is calculated by dividing its tier 1 capital (the numerator of the ratio) by its average total consolidated assets (the denominator of the ratio). The ratio will also be calculated using period-end assets whenever necessary, on a case-by-case basis. For the purpose of this leverage ratio, the definition of tier 1 capital as set forth in the risk-based capital guidelines contained in appendix A of this part will be used.[3] As a general matter, average total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the organization's Consolidated Financial Statements (FR Y–9C Report), less goodwill; amounts of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships, that, in the aggregate, are in excess of 100 percent of tier 1 capital; amounts of nonmortgage servicing assets, and purchased credit card relationships that, in the aggregate, are in excess of 25 percent of tier 1 capital; the amounts of credit-enhancing interest-only strips that are in excess of 25 percent of tier 1 capital; all other identifiable intangible assets; any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from tier 1 capital; and deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of the limitation set forth in section II.B.4. of appendix A of this part.[4]

[3] Tier 1 capital for banking organizations includes common equity, minority interest in the equity accounts of consolidated subsidiaries, qualifying noncumulative perpetual preferred stock, and qualifying cumulative perpetual preferred stock. (Cumulative perpetual preferred stock is limited to 25 percent of tier 1 capital.) In addition, as a general matter, tier 1 capital excludes goodwill; amounts of mortage servicing assets, nonmortgage servicing assets, and purchased credit card relationships that, in the aggregate, exceed 100 percent of tier 1 capital; amounts of nonmortgage servicing assets and purchased credit card relationships that, in the aggregate, exceed 25 percent of tier 1 capital; amounts of credit-enhancing interest-only strips that are in excess of 25 percent of tier 1capital; all other identifiable intangible assets; and deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of certain limitations. The Federal Reserve may exclude certain investments in subsidiaries or associated companies as appropriate.

* * * * *

By order of the Board of Governors of the Federal Reserve System.

Dated: November 8, 2001.

Margaret McCloskey Shanks,

Assistant Secretary of the Board.

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Chapter III

Authority and Issuance

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

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.

[4] Deductions from tier 1 capital and other adjustments are discussed more fully in section II.B. of appendix A of this part.

2236, 2386, as amended by Pub. L. 102–550, 106 Stat. 3672, 4089 (12 U.S.C. 1828 note).

2. In § 325.2:

A. Redesignate paragraphs (g) through (x) as paragraphs (i) through (z);

B. Add new paragraphs (g) and (h);

C. Amend newly designated paragraphs (v) and (x) to read as follows:

§ 325.2 Definitions.

* * * * *

(g)(1) *Credit-enhancing interest-only strip* means 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 transferred assets; and

(ii) Exposes the bank to credit risk directly or indirectly associated with the transferred assets that exceeds a pro rata share of the bank's claim on the assets, whether through subordination provisions or other credit enhancement techniques.

(2) *Reservation of authority.* In determining whether a particular interest cash flow functions, directly or indirectly, as a credit-enhancing interest-only strip, the FDIC will consider the economic substance of the transaction. The FDIC, through the Director of Supervision, or other designated FDIC official reserves the right to identify other interest cash flows or related assets as credit-enhancing interest-only strips.

(h) *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.

* * * * *

(v) *Tier 1 capital or core capital* means the sum of common stockholders' equity, noncumulative perpetual preferred stock (including any related surplus), and minority interests in consolidated subsidiaries, minus all intangible assets (other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships eligible for inclusion in core capital pursuant to § 325.5(f)), minus credit-enhancing interest-only strips that are not eligible for inclusion in core capital pursuant to § 325.5(f), minus deferred tax assets in excess of the limit set forth in § 325.5(g), minus identified losses (to the extent that Tier 1 capital would have been reduced if the appropriate accounting entries to reflect the identified losses had been recorded on the insured depository institution's books), and minus investments in financial subsidiaries subject to 12 CFR part 362, subpart E.

* * * * *

(x) *Total assets* means the average of total assets required to be included in a banking institution's ''Reports of Condition and Income'' (Call Report) or, for savings associations, the consolidated total assets required to be included in the ''Thrift Financial Report,'' as these reports may from time to time be revised, as of the most recent report date (and after making any necessary subsidiary adjustments for state nonmember banks as described in §§ 325.5(c) and 325.5(d) of this part), minus intangible assets (other than mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships eligible for inclusion in core capital pursuant to § 325.5(f)), minus credit-enhancing interest-only strips that are not eligible for inclusion in core capital pursuant to § 325.5(f)), minus deferred tax assets in excess of the limit set forth in § 325.5(g), and minus assets classified loss and any other assets that are deducted in determining Tier 1 capital. For banking institutions, the average of total assets is found in the Call Report schedule of quarterly averages. For savings associations, the consolidated total assets figure is found in Schedule CSC of the Thrift Financial Report.

3. In § 325.3, amend paragraph (b)(1) by changing ''CAMEL'' to ''CAMELS.''

4. In § 325.5, revise paragraphs (f) and (g)(2) to read as follows:

§ 325.5 Miscellaneous.

* * * * *

(f) *Treatment of mortgage servicing assets, purchased credit card relationships, nonmortgage servicing assets, and credit-enhancing interest-only strips.* For purposes of determining Tier 1 capital under this part, mortgage servicing assets, purchased credit card relationships, nonmortgage servicing assets, and credit-enhancing interest-only strips will be deducted from assets and from common stockholders' equity to the extent that these items do not meet the conditions, limitations, and restrictions described in this section. Banks may elect to deduct disallowed servicing assets and disallowed credit-enhancing interest-only strips on a basis that is net of a proportional amount of any associated deferred tax liability recorded on the balance sheet. Any deferred tax liability netted in this manner cannot also be netted against deferred tax assets when determining the amount of deferred tax assets that are dependent upon future taxable income and calculating the maximum allowable amount of these assets under paragraph (g) of this section.

(1) *Valuation.* The fair value of mortgage servicing assets, purchased credit card relationships, nonmortgage servicing assets, and credit-enhancing interest-only strips shall be estimated at least quarterly. The quarterly fair value estimate shall include adjustments for any significant changes in the original valuation assumptions, including changes in prepayment estimates or attrition rates. The FDIC in its discretion may require independent fair value estimates on a case-by-case basis where it is deemed appropriate for safety and soundness purposes.

(2) *Fair value limitation.* For purposes of calculating Tier 1 capital under this part (but not for financial statement purposes), the balance sheet assets for mortgage servicing assets, purchased credit card relationships, and nonmortgage servicing assets will each be reduced to an amount equal to the lesser of:

(i) 90 percent of the fair value of these assets, determined in accordance with paragraph (f)(1) of this section; or

(ii) 100 percent of the remaining unamortized book value of these assets (net of any related valuation allowances), determined in accordance with the instructions for the preparation of the ''Reports of Income and Condition'' (Call Reports).

(3) *Tier 1 capital limitations.* (i)The maximum allowable amount of mortgage servicing assets, purchased credit card relationships, and nonmortgage servicing assets in the aggregate, will be limited to the lesser of:

(A) 100 percent of the amount of Tier 1 capital that exists before the deduction of any disallowed mortgage servicing assets, any disallowed purchased credit card relationships, any disallowed nonmortgage servicing assets, any disallowed credit-enhancing interest-only strips, and any disallowed deferred tax assets; or

(B) The sum of the amounts of mortgage servicing assets, purchased credit card relationships, and nonmortgage servicing assets, determined in accordance with paragraph (f)(2) of this section.

(ii) The maximum allowable amount of credit-enhancing interest-only strips, whether purchased or retained, will be limited to the lesser of:

(A) 25 percent of the amount of Tier 1 capital that exists before the deduction of any disallowed mortgage servicing assets, any disallowed purchased credit card relationships, any disallowed nonmortgage servicing assets, any disallowed credit-enhancing interest-only strips, and any disallowed deferred tax assets; or

(B) The sum of the face amounts of all credit-enhancing interest-only strips.

(4) *Tier 1 capital sublimit.* In addition to the aggregate limitation on mortgage servicing assets, purchased credit card relationships, and nonmortgage servicing assets set forth in paragraph (f)(3) of this section, a sublimit will apply to purchased credit card relationships and nonmortgage servicing assets. The maximum allowable amount of the aggregate of purchased credit card relationships and nonmortgage servicing assets will be limited to the lesser of:

(i) 25 percent of the amount of Tier 1 capital that exists before the deduction of any disallowed mortgage servicing assets, any disallowed purchased credit card relationships, any disallowed nonmortgage servicing assets, any disallowed credit-enhancing interest-only strips, and any disallowed deferred tax assets; or

(ii) The sum of the amounts of purchased credit card relationships and nonmortgage servicing assets determined in accordance with paragraph (f)(2) of this section.

(g) * * *

(2) *Tier 1 capital limitations.* (i) The maximum allowable amount of deferred tax assets that are dependent upon future taxable income, net of any valuation allowance for deferred tax assets, will be limited to the lesser of:

(A) The amount of deferred tax assets that are dependent upon future taxable income that is expected to be realized within one year of the calendar quarter-end date, based on projected future taxable income for that year; or

(B) 10 percent of the amount of Tier 1 capital that exists before the deduction of any disallowed mortgage servicing assets, any disallowed nonmortgage servicing assets, any disallowed purchased credit card relationships, any disallowed credit-enhancing interest-only strips and any disallowed deferred tax assets.

(ii) For purposes of this limitation, all existing temporary differences should be assumed to fully reverse at the calendar quarter-end date. The recorded amount of deferred tax assets that are dependent upon future taxable income, net of any valuation allowance for deferred tax assets, in excess of this limitation will be deducted from assets and from equity capital for purposes of determining Tier 1 capital under this part. The amount of deferred tax assets that can be realized from taxes paid in prior carryback years and from the reversal of existing taxable temporary differences generally would not be deducted from assets and from equity capital. However, notwithstanding the first three sentences in this paragraph, the amount of carryback potential that may be considered in calculating the amount of deferred tax assets that a member of a consolidated group (for tax purposes) may include in Tier 1 capital may not exceed the amount which the member could reasonably expect to have refunded by its parent.

* * * * *

§ 325.103 [Amended]

5. In § 325.103, amend paragraph (b) by revising all references to ''CAMEL'' to read ''CAMELS'.

6. In appendix A to part 325:

A. In the introductory section, second undesignated paragraph remove the last sentence and in the third undesignated paragraph revise the first sentence;

B. In section I, revise paragraph I.A.l. and redesignate footnotes 5 through 10 as footnotes 4 through 9;

C. In section II:

i. Amend paragraph II.A. by designating the first two undesignated paragraphs as l. and 2., respectively, adding a new paragraph 3., and redesignating footnote 11 as footnote 10;

ii. Amend paragraph II.B. by redesignating footnotes 12 through 13 as footnotes 11 through 12, revising paragraph 5, and removing paragraph 6;

iii. Amend paragraph II.C. by redesignating footnotes 15 through 31 as footnotes 16 through 32; under ''*Category 2–20 Percent Risk Weight*'' designating the three undesignated paragraphs as paragraphs a. through c., respectively, and adding a new paragraph d.; under ''*Category 3—50 Percent Risk Weight*'' removing the third undesignated paragraph, designating the three remaining paragraphs as a. through c., respectively, revising newly designated footnote 30, and adding a new paragraph d; revising ''*Category 4—100 Percent Risk Weight*''; and adding a new paragraph entitled ''*Category 5—200 Percent Risk Weight*'';

iv. Amend paragraph II.D. by revising the undesignated introductory paragraph and paragraph II.D.1.; removing footnote 38 and redesignating footnotes 39 through 42 as footnotes 37 through 40.

D. Revise section III;

E. Revise Table I;

F. In Table II:

i. Amend Category 2—20 Percent Risk Weight, by removing paragraph (11), redesignating paragraph (12) as paragraph (11), and adding new paragraph (12);

ii. Amend Category 3—50 Percent Risk Weight, by revising paragraph (3);

iii. Amend Category 4—100 Percent Risk Weight, by revising paragraph (9) and adding a new paragraph (10); and

iv. Following the paragraph titled Category 4—100 Percent Risk Weight, add a new paragraph titled Category 5—200 Percent Risk Weight;

G. Amend Table III by removing references to footnote 1 each time they appear and revising paragraphs (1) through (3) under ''*100 Percent Conversion Factor*''.

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

* * * * *

The framework set forth in this statement of policy consists of (1) a definition of capital for risk-based capital purposes, and (2) a system for calculating risk-weighted assets by assigning assets and off balance sheet items to broad risk categories. * * *

I. * * *

A. * * *

1. *Core capital elements (Tier 1) consists of:*

i. Common stockholders' equity capital (includes common stock and related surplus, undivided profits, disclosed capital reserves that represent a segregation of undivided profits, and foreign currency translation adjustments, less net unrealized holding losses on available-for-sale equity securities with readily determinable fair values);

ii. Noncumulative perpetual preferred stock,[2] including any related surplus; and

iii. Minority interests in the equity capital accounts of consolidated subsidiaries.

At least 50 percent of the qualifying total capital base should consist of Tier 1 capital. Core (Tier 1) capital is defined as the sum of core capital elements minus all intangible assets (other than mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships eligible for inclusion in core capital pursuant to § 325.5(f)),[3] minus credit-enhancing interest-only strips that are not eligible for inclusion in core capital pursuant to § 325.5(f)), and minus any disallowed deferred tax assets.

Although nonvoting common stock, noncumulative perpetual preferred

[2] Preferred stock issues where the dividend is reset periodically based, in whole or in part, upon the bank's current credit standing, including but not limited to, auction rate, money market or remarketable preferred stock, are assigned to Tier 2 capital, regardless of whether the dividends are cumulative or noncumulative.

[3] An exception is allowed for intangible assets that are explicitly approved by the FDIC as part of the bank's regulatory capital on a specific case basis. These intangibles will be included in capital for risk-based capital purposes under the terms and conditions that are specifically approved by the FDIC.

stock, and minority interests in the equity capital accounts of consolidated subsidiaries are normally included in Tier 1 capital, voting common stockholders' equity generally will be expected to be the dominant form of Tier 1 capital. Thus, banks should avoid undue reliance on nonvoting equity, preferred stock and minority interests.

Although minority interests in consolidated subsidiaries are generally included in regulatory capital, exceptions to this general rule will be made if the minority interests fail to provide meaningful capital support to the consolidated bank. Such a situation could arise if the minority interests are entitled to a preferred claim on essentially low risk assets of the subsidiary. Similarly, although credit-enhancing interest-only strips and intangible assets in the form of mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships are generally recognized for risk-based capital purposes, the deduction of part or all of the credit-enhancing interest-only strips, mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships may be required if the carrying amounts of these assets are excessive in relation to their market value or the level of the bank's capital accounts. Credit-enhancing interest-only strips, mortgage servicing assets, nonmortgage servicing assets, purchased credit card relationships and deferred tax assets that do not meet the conditions, limitations and restrictions described in § 325.5(f) and (g) of this part will not be recognized for risk-based capital purposes.

* * * * *

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 in this Appendix A or that imposes risks on a bank that are not commensurate with the risk weight otherwise specified in this Appendix A 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 in this Appendix A or that imposes risks on a bank that are not commensurate with the credit conversion factor otherwise specified in this Appendix A 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 sections II.B and II.C of this appendix A, as well as other relevant factors.

B. * * *

5. *Recourse, Direct Credit Substitutes, Residual Interests and Mortgage- and Asset-Backed Securities.* For purposes of this section II.B.5 of this appendix A, the following definitions will apply.

(a) *Definitions.* (1) *Credit derivative* means a contract that allows one party (the protection purchaser) to transfer the credit risk of an asset or off-balance sheet credit exposure to another party (the protection provider). The value of a credit derivative is dependent, at least in part, on the credit performance of a "reference asset."

(2) *Credit-enhancing interest-only strip* is defined in § 325.2(g).

(3) *Credit-enhancing 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 protect investors from losses arising from credit risk in the assets transferred or the loans serviced. Credit-enhancing 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. Credit-enhancing representations and warranties do not include:

(i) Early-default clauses and similar warranties that permit the return of, or premium refund clauses covering, 1–4 family residential first mortgage loans (as described in section II.C, Category 3–50 Percent Risk Weight, of this appendix A) for a period of 120 days from the date of transfer. These warranties may cover only those loans that were originated within 1 year of the date of transfer;

(ii) Premium refund clauses covering assets guaranteed, in whole or in part, by the U.S. Government, a U.S. Government agency, or a U.S. Government-sponsored agency, provided the premium refund clauses are for a period not to exceed 120 days from the date of transfer; or

(iii) Warranties that permit the return of assets in instances of fraud, misrepresentation, or incomplete documentation.

(4) *Direct credit substitute* means an arrangement in which a bank assumes, in form or in substance, credit risk directly or indirectly associated with an on-or off-balance sheet asset or exposure that was not previously owned by the bank (third-party asset) and the risk assumed by the bank exceeds the *pro rata* share of the bank's interest in the third-party asset. If the bank has no claim on the asset, then the bank's assumption of any credit risk is a direct credit substitute. Direct credit substitutes include, but are not limited to:

(i) Financial standby letters of credit, which includes any letter of credit or similar arrangement, however named or described, that support financial claims on a third party that exceed a bank's *pro rata* share in the financial claim;

(ii) 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;

(iii) Purchased subordinated interests or securities that absorb more than their *pro rata* share of credit losses from the underlying assets. Purchased subordinated interests that are credit-enhancing interest-only strips are subject to the higher capital charge specified in section II.B.5.(f) of this Appendix A;

(iv) 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 or exposure;

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

(vi) Purchased loan servicing assets if the servicer:

(A) Is responsible for credit losses associated with the loans being serviced,

(B) Is responsible for making mortgage servicer cash advances (unless the advances are not direct credit substitutes because they meet the conditions specified in paragraph B.5(a)(9) of this appendix A), or

(C) Makes or assumes credit-enhancing representations and warranties on the serviced loans; and

(vii) Clean-up calls on third party assets. Clean-up calls that are exercisable at the option of the bank (as servicer or as an affiliate of the servicer) when the pool balance is 10 percent or less of the original pool balance are not direct credit substitutes.

(5) *Externally rated* means, with respect to an instrument or obligation, that an instrument or obligation has received a credit rating from at least one

nationally recognized statistical rating organization.

(6) *Face amount* is defined in § 325.2(h).

(7) *Financial asset* means cash, evidence of an ownership interest in an entity, or a contract that conveys to a second entity a contractual right:

(i) To receive cash or another financial instrument from a first entity; or

(ii) To exchange other financial instruments on potentially favorable terms with the first entity.

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

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

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

(9) *Mortgage servicer cash advance* means funds that a residential mortgage 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:

(i) 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, and

(ii) The servicer's entitlement to reimbursement is not subordinated.

(10) *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 (17 CFR 240.15c3–1).

(11) *Recourse* means an arrangement in which a bank retains, in form or in substance, any credit risk directly or indirectly associated with an asset it has sold (in accordance with generally accepted accounting principles) 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 sold, then the retention of any credit risk 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. The following are examples of recourse arrangements:

(i) Credit-enhancing representations and warranties made on the transferred assets;

(ii) Loan servicing assets retained pursuant to an agreement under which the bank:

(A) Is responsible for losses associated with the loans serviced,

(B) Is responsible for making mortgage servicer cash advances (unless the advances are not a recourse obligation because they meet the conditions of paragraph B.5(a)(9) of this appendix A), or

(C) Makes credit-enhancing representations and warranties on the serviced loans;

(iii) Retained subordinated interests that absorb more than their pro rata share of losses from the underlying assets;

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

(v) Loan strips sold without contractual recourse where the maturity of the transferred portion of the loan is shorter than the maturity of the commitment under which the loan is drawn;

(vi) Credit derivative contracts under which the bank retains more than its pro rata share of credit risk on transferred assets; and

(vii) Clean-up calls. Clean-up calls that are exercisable at the option of the bank (as servicer or as an affiliate of the servicer) when the pool balance is 10 percent or less of the original pool balance, are not recourse.

(12) *Residual interest* means any on-balance sheet asset that represents an interest (including a beneficial interest) created by a transfer that qualifies as a sale (in accordance with generally accepted accounting principles) of financial assets, whether through a securitization or otherwise, and that exposes a bank to credit risk directly or indirectly associated with the transferred asset that exceeds a *pro rata* share of that bank's claim on the asset, whether through subordination provisions or other credit enhancement techniques. Residual interests generally include credit-enhancing interest-only strips, spread accounts, cash collateral accounts, retained subordinated interests and other forms of over-collateralization, and similar assets that function as a credit enhancement. Residual interests further include those exposures that, in substance, cause the bank to retain the credit risk of an asset or exposure that had qualified as a residual interest before it was sold. Residual interests generally do not include interests purchased from a third party, except that purchased credit-enhancing interest-only strips are residual interests.

(13) *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.

(14) *Securitization* means the pooling and repackaging by a special purpose entity of assets or other credit exposures into securities that can be sold to investors. Securitization includes transactions that generally create stratified credit risk positions whose performance is dependent upon an underlying pool of credit exposures, including loans and commitments.

(15) *Structured finance program* means 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. Structured finance programs allocate credit risks, generally, between the participants and the credit enhancement provided to the program.

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

(i) Unaffiliated investors to purchase the position; or

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

(b) *Credit equivalent amounts and risk weights of recourse obligations and direct credit substitutes*—(1) *General rule for determining the credit-equivalent amount.* Except as otherwise provided, 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. 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.

(2) *Risk-weight factor.* To determine the bank's risk-weighted assets for an off-balance sheet recourse obligation or a direct credit substitute, 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. The treatment covered in this paragraph (b) is subject to the low-level exposure rule provided in section II.B.5(h)(1) of this appendix A.

(c) *Credit equivalent amount and risk weight of participations in, and syndications of, direct credit substitutes.* Subject to the low-level exposure rule provided in section II.B.5(h)(1) of this appendix A, the credit equivalent amount for a participation interest in, or syndication of, a direct credit substitute (excluding purchased credit-enhancing interest-only strips) is calculated and risk weighted as follows:

(1) *Treatment for direct credit substitutes for which a bank has conveyed a risk participation.* 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. However, 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 party 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. 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.[13]

(2) *Treatment for direct credit substitutes in which the bank has acquired a risk participation.* In the case of a direct credit substitute in which the bank has acquired a risk participation, the acquiring bank's *pro rata* 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.

(3) *Treatment for direct credit substitutes related to syndications.* In the case of a direct credit substitute that takes the form of a syndication where each party is obligated only for its *pro rata* share of the risk and there is no recourse to the originating entity, 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.

(d) *Externally rated positions: credit-equivalent amounts and risk weights.*—(1) *Traded positions.* With respect to a recourse obligation, direct credit substitute, residual interest (other than a credit-enhancing interest-only strip) or mortgage- or asset-backed security that is a "traded position" and that has received an external rating on a long-term position that is one grade below investment grade or better or a short-term position that is investment grade, the bank may multiply the face amount of the position by the appropriate risk weight, determined in accordance with Table A or B of this appendix A, as appropriate.[14] If a traded position receives more than one external rating, the lowest rating will apply.

TABLE A

Long-term rating category	Examples	Risk weight (In 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

TABLE B

Short-term rating category	Examples	Risk weight (In percent)
Highest investment grade	A–1, P–1	20
Second highest investment grade	A–2, P–2	50
Lowest investment grade	A–3, P–3	100

[13] 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.

[14] Stripped mortgage-backed securities and similar instruments, such as interest-only strips that are not credit-enhancing and principal-only strips, must be assigned to the 100% risk category.

(2) *Non-traded positions.* A recourse obligation, direct credit substitute, residual interest (but not a credit-enhancing interest-only strip) or mortgage- or asset-backed security extended in connection with a securitization that is not a ''traded position'' may be assigned a risk weight in accordance with section II.B.5(d)(1) of this appendix A if:

(i) It has been externally rated by more than one NRSRO;

(ii) It has received an external rating on a long-term position that is one category below investment grade or better or a short-term position that is investment grade by all NRSROs providing a rating;

(iii) The ratings are publicly available; and

(iv) The ratings are based on the same criteria used to rate traded positions. If the ratings are different, the lowest rating will determine the risk category to which the recourse obligation, direct credit substitute, residual interest, or mortgage- or asset-backed security will be assigned.

(e) *Senior positions not externally rated.* For a recourse obligation, direct credit substitute, residual interest or mortgage- or asset-backed security that is not externally rated but is senior in all features to a traded position (including collateralization and maturity), a bank may apply a risk weight to the face amount of the senior position in accordance with section II.B.5(d)(1) of this appendix A, based upon the risk weight of the traded position, subject to any current or prospective supervisory guidance and the bank satisfying the FDIC that this treatment is appropriate. This section will apply only if the traded position provides substantial credit support for the entire life of the unrated position.

(f) *Residual interests*—(1) *Concentration limit on credit-enhancing interest-only strips.* In addition to the capital requirement provided by section II.B.5(f)(2) of this appendix A, a bank must deduct from Tier 1 capital the face amount of all credit-enhancing interest-only strips in excess of 25 percent of Tier 1 capital in accordance with § 325.5(f)(3).

(2) *Credit-enhancing interest-only strip capital requirement.* After applying the concentration limit to credit-enhancing interest-only strips in accordance with § 325.5(f)(3), a bank must maintain risk-based capital for a credit-enhancing interest-only strip, equal to the remaining face amount of the credit-enhancing interest-only strip (net of the remaining proportional amount of any existing associated deferred tax liability recorded on the balance sheet), even if the amount of risk-based capital required to be maintained exceeds the full risk-based capital requirement for the assets transferred. Transactions that, in substance, result in the retention of credit risk associated with a transferred credit-enhancing interest-only strip will be treated as if the credit-enhancing interest-only strip was retained by the bank and not transferred.

(3) *Other residual interests capital requirement.* Except as otherwise provided in section II.B.5(d) or (e) of this appendix A, a bank must maintain risk-based capital for a residual interest (excluding a credit-enhancing interest-only strip) equal to the face amount of the residual interest (net of any existing associated deferred tax liability recorded on the balance sheet), even if the amount of risk-based capital required to be maintained exceeds the full risk-based capital requirement for the assets transferred. Transactions that, in substance, result in the retention of credit risk associated with a transferred residual interest will be treated as if the residual interest was retained by the bank and not transferred.

(4) *Residual interests and other recourse obligations.* Where the aggregate capital requirement for residual interests (including credit-enhancing interest-only strips) and recourse obligations arising from the same transfer of assets exceed the full risk-based capital requirement for assets transferred, a bank must maintain risk-based capital equal to the greater of the risk-based capital requirement for the residual interest as calculated under sections II.B.5(f)(2) through (3) of this appendix A or the full risk-based capital requirement for the assets transferred.

(g) *Positions that are not rated by an NRSRO.* A bank's position (other than a residual interest) in a securitization or structured finance program that is not rated by an NRSRO may be risk-weighted based on the bank's determination of the credit rating of the position, as specified in Table C of this appendix A, multiplied by the face amount of the position. In order to qualify for this treatment, the bank's system for determining the credit rating of the position must meet one of the three alternative standards set out in section II.B.5(g)(1) through (3) of this appendix A.

TABLE C

Rating category	Examples	Risk Weight (In percent)
Investment grade	BBB or better	100
One category below investment grade	BB	200

(1) *Internal risk rating used for asset-backed programs.* A bank extends a direct credit substitute (but not a purchased credit-enhancing interest-only strip) to an asset-backed commercial paper program sponsored by the bank and the bank is able to demonstrate to the satisfaction of the FDIC, prior to relying upon its use, that the bank's internal credit risk rating system is adequate. Adequate internal credit risk rating systems usually contain the following criteria:[15]

(i) The internal credit risk rating 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;

(ii) 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;

(iii) The internal credit risk rating 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;

(iv) The internal credit risk rating system identifies gradations of risk among ''pass'' assets and other risk positions;

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

(v) The internal credit risk rating system must have clear, explicit criteria (including for subjective factors), that are used to classify assets into each internal risk grade;

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

(vii) An internal audit procedure should periodically verify that internal risk ratings are assigned in accordance with the bank's established criteria;

(viii) 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

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

(2) *Program Ratings.* A bank extends a direct credit substitute or retains a recourse obligation (but not a residual interest) in connection with a structured finance program and an NRSRO has reviewed the terms of the program 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 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. In order to rely on a program rating, the bank must demonstrate to the FDIC's satisfaction that the credit risk rating assigned to the program meets the same standards generally used by NRSROs for rating traded positions. The bank must also demonstrate to the FDIC's satisfaction that the criteria underlying the NRSRO's assignment of ratings for the program are satisfied for the particular position issued by the bank. If a bank participates in a securitization sponsored by another party, the FDIC may authorize the bank to use this approach based on a program rating obtained by the sponsor of the program.

(3) *Computer Program.* A bank is using an acceptable credit assessment computer program that has been developed by an NRSRO to determine the rating of a direct credit substitute or recourse obligation (but not a residual interest) extended in connection with a structured finance program. In order to rely on the rating determined by the computer program, the bank must demonstrate to the FDIC's satisfaction that ratings under the program correspond credibly and reliably with the ratings of traded positions. The bank must also demonstrate to the FDIC's satisfaction the credibility of the program in financial markets, the reliability of the program in assessing credit risk, the applicability of the program to the bank's position, and the proper implementation of the program.

(h) *Limitations on risk-based capital requirements*—(1) *Low-level exposure rule.* If the maximum exposure to loss retained or assumed by a bank in connection with a recourse obligation, a direct credit substitute, or a residual interest is less than the effective risk-based capital requirement for the credit-enhanced assets, the risk-based capital required under this appendix A is limited to the bank's maximum contractual exposure, less any recourse liability account established in accordance with generally accepted accounting principles. This limitation does not apply when a bank provides credit enhancement beyond any contractual obligation to support assets it has sold.

(2) *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.

(3) *Related on-balance sheet assets.* If a recourse obligation or direct credit substitute also appears as a balance sheet asset, the asset is risk-weighted only under this section II.B.5 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, the on-balance sheet servicing assets and the related recourse obligations or direct credit substitutes must both be separately risk weighted and incorporated into the risk-based capital calculation.

(i) *Alternative Capital Calculation for Small Business Obligations.*

(1) *Definitions.* For purposes of this section II.B. 5(i):

(i) *Qualified bank means a bank that:*

(A) Is well capitalized as defined in § 325.103(b)(1) without applying the capital treatment described in this section II.B.5(i), or

(B) Is adequately capitalized as defined in § 325.103(b)(2) without applying the capital treatment described in this section II.B.5(i) and has received written permission by order of the FDIC to apply the capital treatment described in this section II.B.5(i).

(iii) *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.

(2) *Capital and reserve requirements.* Notwithstanding the risk-based capital treatment outlined in any other paragraph (other than paragraph (i) of this section II.B.5), with respect to a transfer with recourse of a small business loan or a lease to a small business of personal property that is a sale under generally accepted accounting principles, and for which the bank establishes and maintains a non-capital reserve under generally accepted accounting principles sufficient to meet the reasonable estimated liability of the bank under the recourse arrangement; a qualified bank may elect to include only the face amount of its recourse in its risk-weighted assets for purposes of calculating the bank's risk-based capital ratio.

(3) *Limit on aggregate amount of recourse.* The total outstanding amount of recourse retained by a qualified bank with respect to transfers of small business loans and leases to small businesses of personal property and included in the risk-weighted assets of the bank as described in section II.B.5(i)(2) of this appendix A may not exceed 15 percent of the bank's total risk-based capital, unless the FDIC specifies a greater amount by order.

(4) *Bank that ceases to be qualified or that exceeds aggregate limit.* If a bank ceases to be a qualified bank or exceeds the aggregate limit in section II.B.5(i)(3) of this appendix A, the bank may continue to apply the capital treatment described in section II.B.5(i)(2) of this appendix A to transfers of small business loans and leases to small businesses of personal property that occurred when the bank was qualified and did not exceed the limit.

(5) *Prompt correction action not affected.* (i) A bank shall compute its capital without regard to this section II.B.5(i) for purposes of prompt corrective action (12 U.S.C. 1831o) unless the bank is a well capitalized bank (without applying the capital treatment described in this section

II.B.5(i)) and, after applying the capital treatment described in this section II.B.5(i), the bank would be well capitalized.

(ii) A bank shall compute its capital without regard to this section II.B.5(i) for purposes of 12 U.S.C. 1831o(g) regardless of the bank's capital level.

* * * * *

C. * * *

Category 2–20 Percent Risk Weight.

* * * * *

d. This category also includes recourse obligations, direct credit substitutes, residual interests (other than a credit-enhancing interest-only strip) and asset- or mortgage-backed securities rated in the highest or second highest investment grade category, e.g., AAA, AA, in the case of long-term ratings, or the highest rating category, e.g., A–1, P–1, in the case of short-term ratings.

Category 3—50 Percent Risk Weight.

* * * * *

b. * * *[30] * * *

* * * * *

d. This category also includes recourse obligations, direct credit substitutes, residual interests (other than a credit-enhancing interest-only strip) and asset- or mortgage-backed securities rated in the third highest investment grade category, e.g., A, in the case of long-term ratings, or the second highest rating category, e.g., A–2, P–2, in the case of short-term ratings.

Category 4—100 Percent Risk Weight. (a) All assets not included in the categories above in section II.C of this appendix A, except the assets specifically included in the 200 percent category below in section II.C of this appendix A and assets that are otherwise risk weighted in accordance with section II.B.5 of this appendix A, 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;[33]

(2) All claims on foreign and domestic private-sector obligors not included in the categories above in section II.C of this appendix A (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;[34]

(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) Recourse obligations, direct credit substitutes, residual interests (other than a credit-enhancing interest-only strip) and asset-or mortgage-backed securities rated in the lowest investment grade category, e.g., BBB, as well as certain positions (but not residual interests) which the bank rates pursuant to section section II.B.5(g) of this appendix A.;

(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;

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

(11) Stripped mortgage-backed securities and similar instruments, such as interest-only strips that are not credit-enhancing and principal-only strips.

(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 purchased credit card relationships.

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

(a) Externally rated recourse obligations, direct credit substitutes, residual interests (other than a credit-enhancing interest-only strip), and asset- and mortgage-backed securities that are rated one category below the lowest investment grade category, e.g., BB, to the extent permitted in section II.B.5(d) of this appendix A; and

(b) A position (but not a residual interest) in a securitization or structured finance program that is not rated by an NRSRO 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.(g) 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 as otherwise specified in section II.B.5 of this appendix A for direct credit substitutes and recourse obligations. 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.[35] 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.

[30] 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 bank 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.

[33] Such assets include all non-local 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.

[34] 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.

[35] 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.

(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,[36] 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 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.

* * * * *

III. Minimum Risk-Based Capital Ratio

Subject to section II.B.5. of this appendix A, banks generally will be expected to meet a minimum ratio of qualifying total capital to risk-weighted assets of 8 percent, of which at least 4 percentage points should be in the form of core capital (Tier 1). Any bank that does not meet the minimum risk-based capital ratio, or whose capital is otherwise considered inadequate, generally will be expected to develop and implement a capital plan for achieving an adequate level of capital, consistent with the provisions of this risk-based capital framework and § 325.104, the specific circumstances affecting the individual bank, and the requirements of any related agreements between the bank and the FDIC.

TABLE I.—DEFINITION OF QUALIFYING CAPITAL

Components	Minimum requirements
(1) Core Capital (Tier 1)	Must equal or exceed 4% of weighted-risk assets.
(a) Common stockholders' equity	No limit.[1]
(b)Noncumulative perpetual preferred stock and any related surplus.	No limit.[1]
(c) Minority interest in equity accounts of consolidated	No limit.[1]
(d) Less: All intangible assets other than certain mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships.	([2]).
(e) Less: Certain credit-enhancing interest-only strips	([3]).
(f) Less: Certain deferred tax assets	([4]).
(2) Supplementary Capital (Tier 2)	Total of tier 2 is limited to 100% of tier 1.[5]
(a) Allowance for loan and lease losses	Limited to 1.25% of weighted-risk assets.[5]
(b) Unrealized gains on certain equity securities.[6]	
Limited to 45% of pretax net unrealized gains.[6].	
(c) Cumulative perpetual and long-term preferred stock (original maturity of 20 years or more) and any related surplus.	No limit within tier 2; long-term preferred is amortized for capital purposes as it approaches maturity.
(d) Auction rate and similar preferred stock (both cumulative and non-cumulative).	No limit within Tier 2.
(e) Hybrid capital instruments (including mandatory convertible debt securities).	No limit within Tier 2.
(f) Term subordinated debt and intermediate-term preferred stock (original weighted average maturity of five years or more).	Term subordinated debt and intermediate-term preferred stock are limited to 50% of Tier 1 [5] and amortized for capital purposes as they approach maturity.
(3) Deductions (from sum of tier 1 and tier 2):	
(a) Investments in banking and finance subsidiaries that are not consolidated for regulatory capital purposes.	
(b) Intentional, reciprocal cross-holdings of capital securities issued by banks.	
(c) Other deductions (such as investment in other subsidiaries or joint ventures) as determined by supervisory authority.	On a case-by-case basis or as a matter of policy after formal consideration of relevant issues.
(4) Total Capital	Must equal or exceed 8% or weighted-risk assets.

[1] No express limits are placed on the amounts of nonvoting common, noncumulative perpetual preferred stock, and minority interests that may be recognized as part of Tier 1 capital. However, voting common stockholders' equity capital generally will be expected to be the dominant form of Tier 1 capital and banks should avoid undue reliance on other Tier 1 capital elements.

[2] The amounts of mortgage servicing assets, nonmortgage servicing assets and purchased credit card relationships that can be recognized for purposes of calculating Tier 1 capital are subject to the limitations set forth in § 325.5(f). All deductions are for capital purposes only; deductions would not affect accounting treatment.

[3] The amounts of credit-enhancing interest-only strips that can be recognized for purposes of calculating Tier 1 capital are subject to the limitations set forth in § 325.5(f).

[4] Deferred tax assets are subject to the capital limitations set forth in § 325.5(g).

[5] Amounts in excess of limitations are permitted but do not qualify as capital.

[6] Unrealized gains on equity securities are subject to the capital limitations set forth in paragraph I.A2.(f) of appendix A to part 325.

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

* * * * *

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

* * * * *

Category 2—20 Percent Risk Weight.

* * * * *

(12) Recourse obligations, direct credit substitutes, residual interests (other than credit-enhancing interest-only strips) and asset- or mortgage-backed securities rated in either of the two highest investment grade categories, e.g., AAA or AA, in the case of long-term ratings, or the highest rating category, e.g., A–1, P–1, in the case of short-term ratings.

Category 3—50 Percent Risk Weight.

* * * * *

(3) Recourse obligations, direct credit substitutes, residual interests (other than credit-enhancing interest-only strips) and asset- or mortgage-backed securities rated in the third-highest investment grade category, e.g., A, in the case of long-term ratings, or the second highest rating category, e.g., A–2, P–2, in the case of short-term ratings.

* * * * *

Category 4—100 Percent Risk Weight.

* * * * *

(9) Recourse obligations, direct credit substitutes, residual interests (other than credit-enhancing interest-only strips) and asset- or mortgage-backed securities rated in the lowest investment grade category, e.g., BBB, as well as certain positions (but not residual interests) which the bank rates pursuant to section II.B.5(g) of this appendix A.

(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.

(1) Externally rated recourse obligations, direct credit substitutes, residual interests (other than credit-enhancing interest-only strips), and asset- and mortgage-backed securities that are rated one category below the lowest investment grade category, e.g., BB, to the extent permitted in section II.B.5(d) of this appendix A; and

(2) A position (but not a residual interest) extended in connection with a securitization or structured financing program that is not rated by an NRSRO 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.(g) of this appendix A.

* * * * *

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 and recourse obligations (unless a different treatment is otherwise specified). For risk participations in such arrangements 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.

* * * * *

7. In appendix B to part 325:

A. Amend section I by changing "CAMEL" to "CAMELS" in the first undesignated paragraph and in the second undesignated paragraph by removing "by December 31, 1992 (and at least 7.25 percent by December 31, 1990)."

B. Amend section III by removing the second undesignated paragraph.

C. In section IV. paragraph A:

i. Amend the first undesignated paragraph by removing "in accordance with Accounting Principles Board Opinion No. 16, as amended,';

ii. Remove the second undesignated paragraph; and

iii. Amend the new second undesignated paragraph by changing "§ 325(t)" to "§ 325.2(v)."

By order of the Board of Directors.

Dated at Washington, DC, this 23rd day of October, 2001.

Federal Deposit Insurance Corporation.

James D. LaPierre,

Deputy 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 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:

A. Revising the definitions of direct credit substitute and recourse;

B. Adding definitions of credit derivative, credit-enhancing interest-only strips, credit-enhancing representations and warranties, face amount, financial asset, financial standby letter of credit, nationally recognized statistical rating organization, performance-based standby letter of credit, residual interest, risk participation, securitization, servicer cash advance, structured financing program, and traded position; and

C. Removing the definition of high quality mortgage related securities to read as follows:

§ 567.1 Definitions.

* * * * *

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

Credit-enhancing interest-only strip. (1) The term *credit-enhancing interest-only strip* means 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 transferred assets; and

(ii) Exposes the savings association to credit risk directly or indirectly associated with the transferred assets that exceeds its *pro rata* share of the savings association's claim on the assets whether through subordination provisions or other credit enhancement techniques.

(2) OTS reserves the right to identify other cash flows or related interests as a credit-enhancing interest-only strip. In determining whether a particular interest cash flow functions as a credit-enhancing interest-only strip, OTS will consider the economic substance of the transaction.

Credit-enhancing representations and warranties. (1) The term *credit-enhancing 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 savings association to protect investors from losses arising from credit risk in the assets transferred or loans serviced.

(2) Credit-enhancing representations and warranties include promises to protect a party from losses resulting from the default or nonperformance of

[4] In general, 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 item to a risk weight category.

another party or from an insufficiency in the value of the collateral.

(3) Credit-enhancing representations and warranties do not include:

(i) Early-default clauses and similar warranties that permit the return of, or premium refund clauses covering, qualifying mortgage loans for a period not to exceed 120 days from the date of transfer. These warranties may cover only those loans that were originated within one year of the date of the transfer;

(ii) Premium refund clauses covering assets guaranteed, in whole or in part, by the United States government, a United States government agency, or a United States government-sponsored enterprise, provided the premium refund clause is for a period not to exceed 120 days from the date of transfer; or

(iii) Warranties that permit the return of assets in instances of fraud, misrepresentation or incomplete documentation.

* * * * *

Direct credit substitute. The term *direct credit substitute* means an arrangement in which a savings association assumes, in form or in substance, credit risk associated with an on-or off-balance sheet asset or exposure that was not previously owned by the savings association (third-party asset) and the risk assumed by the savings association exceeds the *pro rata* share of the savings association's interest in the third-party asset. If a savings association has no claim on the third-party asset, then the savings association's assumption of any credit risk is a direct credit substitute. Direct credit substitutes include:

(1) Financial standby letters of credit that support financial claims on a third party that exceed a savings association's *pro rata* share in the financial claim;

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

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

(4) Credit derivative contracts under which the savings association assumes more than its *pro rata* share of credit risk on a third-party asset or exposure;

(5) Loans or lines of credit that provide credit enhancement for the financial obligations of a third party;

(6) Purchased loan servicing assets if the servicer is responsible for credit losses or if the servicer makes or assumes credit-enhancing representations and warranties with respect to the loans serviced. Servicer cash advances as defined in this section are not direct credit substitutes; and

(7) Clean-up calls on third party assets. However, clean-up calls that are 10 percent or less of the original pool balance and that are exercisable at the option of the savings association are not direct credit substitutes.

* * * * *

Face amount. The term *face amount* means the notational principal, or face value, amount of an off-balance sheet item or the amortized cost of an on-balance sheet asset.

Financial asset. The term *financial asset* means cash or other monetary instrument, evidence of debt, evidence of an ownership interest in an entity, or a contract that conveys a right to receive or exchange cash or another financial instrument from another party.

Financial standby letter of credit. The term *financial standby letter of credit* means a letter of credit or similar arrangement that represents an irrevocable obligation to a third-party beneficiary:

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

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

* * * * *

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

* * * * *

Recourse. The term *recourse* means a savings association's retention, in form or in substance, of any credit risk directly or indirectly associated with an asset it has sold (in accordance with generally accepted accounting principles) that exceeds a *pro rata* share of that savings association's claim on the asset. If a savings association has no claim on a asset it has sold, then the retention of any credit risk is recourse. A recourse obligation typically arises when a savings association transfers assets in a sale 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 savings association provides credit enhancement beyond any contractual obligation to support assets it has sold. Recourse obligations include:

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

(2) Loan servicing assets retained pursuant to an agreement under which the savings association will be responsible for losses associated with the loans serviced. Servicer cash advances as defined in this section are not recourse obligations;

(3) Retained subordinated interests 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;

(5) Loan strips sold without contractual recourse where the maturity of the transferred portion of the loan is shorter than the maturity of the commitment under which the loan is drawn;

(6) Credit derivatives issued that absorb more than the savings association's *pro rata* share of losses from the transferred assets; and

(7) Clean-up calls on assets the savings association has sold. However, clean-up calls that are 10 percent or less of the original pool balance and that are exercisable at the option of the savings association are not recourse arrangements.

* * * * *

Residual interest. (1) The term *residual interest* means any on-balance sheet asset that:

(i) Represents an interest (including a beneficial interest) created by a transfer that qualifies as a sale (in accordance with generally accepted accounting principles) of financial assets, whether through a securitization or otherwise; and

(ii) Exposes a savings association to credit risk directly or indirectly associated with the transferred asset that exceeds a *pro rata* share of that savings association's claim on the asset, whether through subordination provisions or other credit enhancement techniques.

(2) Residual interests generally include credit-enhancing interest-only strips, spread accounts, cash collateral accounts, retained subordinated interests (and other forms of overcollateralization), and similar assets that function as a credit enhancement.

(3) Residual interests further include those exposures that, in substance, cause the savings association to retain the credit risk of an asset or exposure that had qualified as a residual interest before it was sold.

(4) Residual interests generally do not include assets purchased from a third party. However, a credit-enhancing interest-only strip that is acquired in any asset transfer is a residual interest.

* * * * *

Risk participation. The term *risk participation* means a participation in which the originating party 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.

* * * * *

Securitization. The term *securitization* means the pooling and repackaging by a special purpose entity of assets or other credit exposures that can be sold to investors. *Securitization* includes transactions that create stratified credit risk positions whose performance is dependent upon an underlying pool of credit exposures, including loans and commitments.

Servicer cash advance. The term *servicer cash advance* means funds that a residential 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 servicer cash advance is not a recourse obligation or a direct credit substitute if:

(1) 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

(2) For any one loan, the servicer's obligation to make nonreimbursable advances is contractually limited to an insignificant amount of the outstanding principal amount on that loan.

* * * * *

Structured financing program. The term *structured financing program* means a program where receivable interests and asset-or mortgage-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. Structured financing programs allocate credit risk, generally, between the participants and credit enhancement provided to the program.

* * * * *

Traded position. The term *traded position* means a position retained, assumed, or issued in connection with a securitization that is rated by a NRSRO, where there is a reasonable expectation that, in the near future, the rating will be relied upon by:

(1) Unaffiliated investors to purchase the security; or

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

* * * * *

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 association's 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. Amend § 567.5 by adding a new paragraph (a)(2)(iii) to read as follows:

§ 567.5 Components of capital.

(a) * * *

(2) * * *

(iii) Credit-enhancing interest-only strips that are not includable in core capital under § 567.12 of this part are deducted from assets and capital in computing core capital.

* * * * *

5. Section 567.6 is amended by:

A. Revising paragraph (a) introductory text;

B. Revising paragraph (a)(1) introductory text and paragraphs (a)(1)(ii)(R), (a)(1)(iii)(C), (a)(1)(iv)(J), and (a)(1)(iv)(M);

C. Removing and reserving paragraphs (a)(1)(ii)(H) and (a)(1)(iv)(N);

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

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

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

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

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

I. 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 (computed under paragraph (a)(1) of this section), plus risk-weighted off-balance sheet activities (computed under paragraph (a)(2) of this section), plus risk-weighted recourse obligations, direct credit substitutes, and certain other positions (computed under paragraph (b) of this section). Assets not included (*i.e.,* deducted from capital) 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 are:

* * * * *

(ii) * * *

(R) Claims on, or guaranteed by depository institutions other than the central bank, incorporated in a non-OECD country, with a remaining maturity of one year or less;

* * * * *

(iii) * * *

(C) Privately-issued mortgage-backed securities (*i.e.,* those that do not carry the guarantee of a government or government sponsored entity) representing an interest in qualifying mortgage loans or qualifying multifamily mortgage loans. If the security is backed by qualifying multifamily mortgage loans, the savings association must receive timely payments of principal and interest in accordance with the terms of the security. Payments will generally be considered timely if they are not 30 days past due;

* * * * *

(iv) * * *

(J) Debt securities not otherwise described in this section;

* * * * *

(M) Interest-only strips receivable, other than credit-enhancing interest-only strips;

* * * * *

(2) *Off-balance sheet items.* 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 bankers' 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 certain other positions.* (1) *In general.* Except as otherwise permitted in this paragraph (b), to determine the risk-weighted asset amount for a recourse obligation or a direct credit substitute (but not a residual interest):

(i) Multiply the full amount of the credit-enhanced assets for which the savings association directly or indirectly retains or assumes credit risk by a 100 percent conversion factor. (For a direct credit substitute that is an on-balance sheet asset (e.g., a purchased subordinated security), a savings association must use the amount of the direct credit substitute and the full amount of the asset its supports, *i.e.,* all the more senior positions in the structure); and

(ii) Assign this credit equivalent amount to the risk-weight category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral. Paragraph (a)(1) of this section lists the risk-weight categories.

(2) *Residual interests.* Except as otherwise permitted under this paragraph (b), a savings association must maintain risk-based capital for residual interests as follows:

(i) *Credit-enhancing interest-only strips.* After applying the concentration limit under § 567.12(e)(2) of this part, a saving association must maintain risk-based capital for a credit-enhancing interest-only strip equal to the remaining amount of the strip (net of any existing associated deferred tax liability), even if the amount of risk-based capital that must be maintained exceeds the full risk-based capital requirement for the assets transferred. Transactions that, in substance, result in the retention of credit risk associated with a transferred credit-enhancing interest-only strip are treated as if the strip was retained by the savings association and was not transferred.

(ii) *Other residual interests.* A saving association must maintain risk-based capital for a residual interest (excluding a credit-enhancing interest-only strip) equal to the face amount of the residual interest (net of any existing associated deferred tax liability), even if the amount of risk-based capital that must be maintained exceeds the full risk-based capital requirement for the assets transferred. Transactions that, in substance, result in the retention of credit risk associated with a transferred residual interest are treated as if the residual interest was retained by the savings association and was not transferred.

(iii) *Residual interests and other recourse obligations.* Where a savings association holds a residual interest (including a credit-enhancing interest-only strip) and another recourse obligation in connection with the same transfer of assets, the savings association must maintain risk-based capital equal to the greater of:

(A) The risk-based capital requirement for the residual interest as calculated under paragraph (b)(2)(i) through (ii) of this section; or

(B) The full risk-based capital requirement for the assets transferred, subject to the low-level recourse rules under paragraph (b)(7) of this section.

(3) *Ratings-based approach*—(i) *Calculation.* A savings association may calculate the risk-weighted asset amount for an eligible position described in paragraph (b)(3)(ii) of this section by multiplying the face amount of the position by the appropriate risk weight determined in accordance with Table A or B of this section.

Note: Stripped mortgage-backed securities or other similar instruments, such as interest-only and principal-only strips, that are not credit enhancing must be assigned to the 100% risk-weight category.

TABLE A

Long term rating category	Risk weight (In percent)
Highest or second highest investment grade	20
Third highest investment grade	50
Lowest investment grade	100
One category below investment grade	200

TABLE B

Short term rating category	Risk weight (In percent)
Highest investment grade	20
Second highest investment grade	50
Lowest investment grade	100

(ii) *Eligibility.* (A) *Traded positions.* A position is eligible for the treatment described in paragraph (b)(3)(i) of this section, if:

(*1*) The position is a recourse obligation, direct credit substitute, residual interest, or asset- or mortgage-backed security and is not a credit-enhancing interest-only strip;

(*2*) The position is a traded position; and

(*3*) The NRSRO has rated a long term position as one grade below investment grade or better or a short term position as investment grade. If two or more NRSROs assign ratings to a traded position, the savings association must use the lowest rating to determine the appropriate risk-weight category under paragraph (b)(3)(i) of this section.

(B) *Non-traded positions.* A position that is not traded is eligible for the treatment described in paragraph (b)(3)(i) of this section if:

(*1*) The position is a recourse obligation, direct credit substitute, residual interest, or asset- or mortgage-backed security extended in connection with a securitization and is not a credit-enhancing interest-only strip;

(*2*) More than one NRSRO rate the position;

(*3*) All of the NRSROs that provide a rating rate a long term position as one grade below investment grade or better or a short term position as investment grade. If the NRSROs assign different ratings to the position, the savings association must use the lowest rating to determine the appropriate risk-weight category under paragraph (b)(3)(i) of this section;

(*4*) The NRSROs base their ratings on the same criteria that they use to rate securities that are traded positions; and

(*5*) The ratings are publicly available.

(C) *Unrated senior positions.* If a recourse obligation, direct credit substitute, residual interest, or asset- or mortgage-backed security is not rated by an NRSRO, but is senior or preferred in all features to a traded position (including collateralization and maturity), the savings association may risk-weight the face amount of the senior position under paragraph (b)(3)(i) of this section, based on the rating of the traded position, subject to supervisory guidance. The savings association must

satisfy OTS that this treatment is appropriate. This paragraph (b)(3)(i)(C) applies only if the traded position provides substantive credit support to the unrated position until the unrated position matures.

(4) *Certain positions that are not rated by NRSROs.* (i) *Calculation.* A savings association may calculate the risk-weighted asset amount for eligible position described in paragraph (b)(4)(ii) of this section based on the savings association's determination of the credit rating of the position. To risk-weight the asset, the savings association must multiply the face amount of the position by the appropriate risk weight determined in accordance with Table C of this section.

TABLE C

Rating category	Risk weight (In percent)
Investment grade	100
One category below investment grade	200

(ii) *Eligibility.* A position extended in connection with a securitization is eligible for the treatment described in paragraph (b)(4)(i) of this section if it is not rated by an NRSRO, is not a residual interest, and meets the one of the three alternative standards described in paragraph (b)(4)(ii)(A), (B), or (C) below of this section:

(A) *Position rated internally.* A direct credit substitute, but not a purchased credit-enhancing interest-only strip, is eligible for the treatment described under paragraph (b)(4)(i) of this section, if the position is assumed in connection with an asset-backed commercial paper program sponsored by the savings association. Before it may rely on an internal credit risk rating system, the saving association must demonstrate to OTS's satisfaction that the system is adequate. Adequate internal credit risk rating systems typically:

(*1*) Are an integral part of the savings association's risk management system that explicitly incorporates the full range of risks arising from the savings association's participation in securitization activities;

(*2*) Link internal credit ratings to measurable outcomes, such as the probability that the position will experience any loss, the expected loss on the position in the event of default, and the degree of variance in 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 among ''pass'' assets and other risk positions;

(*5*) Use clear, explicit criteria to classify assets into each internal rating grade, including subjective factors;

(*6*) Employ independent credit risk management or loan review personnel to assign or review the credit risk 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 credit risk ratings 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 rating system, as needed; and

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

(B) *Program ratings.* (*1*) A recourse obligation or direct credit substitute, but not a residual interest, is eligible for the treatment described in paragraph (b)(4)(i) of this section, if the position is retained or assumed in connection with a structured finance program and an NRSRO has reviewed the terms of the program and stated a rating for positions associated with the program. If the program has options for different combinations of assets, standards, internal or external credit enhancements and other relevant factors, and the NRSRO specifies ranges of rating categories to them, the savings association may apply the rating category applicable to the option that corresponds to the savings association's position.

(*2*) To rely on a program rating, the savings association must demonstrate to OTS's satisfaction that that the credit risk rating assigned to the program meets the same standards generally used by NRSROs for rating traded positions. The savings association must also demonstrate to OTS's satisfaction that the criteria underlying the assignments for the program are satisfied by the particular position.

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

(C) *Computer program.* A recourse obligation or direct credit substitute, but not a residual interest, is eligible for the treatment described in paragraph (b)(4)(i) of this section, if the position is extended in connection with a structured financing program and the savings association uses an acceptable credit assessment computer program to determine the rating of the position. An NRSRO must have developed the computer program and the savings association must demonstrate to OTS's satisfaction that the ratings under the program correspond credibly and reliably with the rating of traded positions.

(5) *Alternative capital computation for small business obligations*—(i) *Definitions.* For the purposes of this paragraph (b)(5):

(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 this paragraph (b)(5); or

(*2*) Is adequately capitalized as defined in § 565.4 of this chapter without applying the capital treatment described in this paragraph (b)(5) and has received written permission from the OTS to apply that capital treatment.

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

(ii) *Capital requirement.* Notwithstanding any other provision of this paragraph (b), 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 recourse in its risk-weighted assets. 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)(5)(ii) of this section, may not exceed 15 percent of the association's total capital computed under § 567.5(c).

(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)(5)(iii) of this section, the savings association may continue to apply the capital treatment described in

paragraph (b)(5)(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)(5) 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)(5) 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)(5) for the purposes of applying 12 U.S.C. 1381o(g), regardless of the association's capital level.

(6) *Risk participations and syndications of direct credit substitutes.* A savings association must calculate the risk-weighted asset amount for a risk participation in, or syndication of, a direct credit substitute as follows:

(i) If a savings association conveys a risk participation in a direct credit substitute, the savings association must convert the full amount of the assets that are supported by the direct credit substitute to a credit equivalent amount using a 100 percent conversion factor. The savings association must assign the *pro rata* share of the credit equivalent amount that was conveyed through the risk participation 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 party acquiring the participation. The savings association must assign the *pro rata* share of the credit equivalent amount that was not participated out to the risk-weight category appropriate to the obligor, after considering any associated guarantees or collateral.

(ii) If a savings association acquires a risk participation in a direct credit substitute, the savings association must multiply its *pro rata* share of the direct credit substitute by the full amount of the assets that are supported by the direct credit substitute, and convert this amount to a credit equivalent amount using a 100 percent conversion factor. The savings association must assign the resulting credit equivalent amount to the risk-weight category appropriate to the obligor in the underlying transaction, after considering any associated guarantees or collateral.

(iii) If the savings association holds a direct credit substitute in the form of a syndication where each savings association or other participant is obligated only for its *pro rata* share of the risk and there is no recourse to the originating party, the savings association must calculate the credit equivalent amount by multiplying only its *pro rata* share of the assets supported by the direct credit substitute by a 100 percent conversion factor. The savings association must assign the resulting credit equivalent amount to the risk-weight category appropriate to the obligor in the underlying transaction after considering any associated guarantees or collateral.

(7) *Limitations on risk-based capital requirements*—(i) *Low-level exposure rule.* If the maximum contractual exposure to loss retained or assumed by a savings association is less than the effective risk-based capital requirement, as determined in accordance with this paragraph (b), for the assets supported by the savings association's position, the risk-based capital requirement is limited to the savings association's contractual exposure less any recourse liability account established in accordance with generally accepted accounting principles. This limitation does not apply when a savings association provides credit enhancement beyond any contractual obligation to support assets it has sold.

(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, it must hold risk-based capital to support the recourse obligation and that percentage of the mortgage-related security or participation certificate that is not covered by the recourse obligation. The total amount of risk-based capital required for the security (or certificate) and the recourse obligation is limited to the risk-based 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.* If an asset is included in the calculation of the risk-based capital requirement under this paragraph (b) and also appears as an asset on the savings association's balance sheet, the savings association must risk-weight the asset only under this paragraph (b), except in the case of loan servicing assets and similar arrangements with embedded recourse obligations or direct credit substitutes. In that case, the savings association must separately risk-weight the on-balance sheet servicing asset and the related recourse obligations and direct credit substitutes under this section, and incorporate these amounts into the risk-based capital calculation.

(8) *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).

6. Amend § 567.9 by revising paragraph (c)(1) to read as follows:

§ 567.9 Tangible capital.

* * * * *

(c) * * *

(1) Intangible assets (as defined in § 567.1), servicing assets, and credit-enhancing interest-only strips not includable in tangible capital under § 567.12.

* * * * *

7. Section 567.11 is amended by redesignating paragraph (c) as paragraph (c)(1) and adding new paragraphs (c)(2) and (3) to read as follows:

§ 567.11 Reservation of authority.

* * * * *

(c) * * *

(2) Notwithstanding § 567.6 of this part, OTS will look to the substance of a transaction and may find that the assigned risk weight for any asset, or credit equivalent amount or credit conversion factor for any off-balance sheet item does not appropriately reflect the risks imposed on the savings association. OTS may require the savings association to apply another risk-weight, credit equivalent amount, or credit conversion factor that OTS deems appropriate.

(3) If this part does not specifically assign a risk weight, credit equivalent amount, or credit conversion factor, OTS may assign any risk weight, credit equivalent amount, or credit conversion factor that it deems appropriate. In making this determination, OTS will consider the risks associated with the asset or off-balance sheet item as well as other relevant factors.

8. Section 567.12 is amended by:

A. Revising the section heading;

B. Revising paragraph (a);

C. Adding a new paragraph (b)(4), and

D. Revising paragraph (e) to read as follows:

§ 567.12 Intangible assets, servicing assets, and credit-enhancing interest-only strips.

(a) *Scope.* This section prescribes the maximum amount of intangible assets, servicing assets, and credit-enhancing interest-only strips that savings associations may include in calculating tangible and core capital.

(b) * * *

(4) Credit-enhancing interest-only strips may be included (that is not deducted) in computing core capital subject to the restrictions of this section, and may be included in tangible capital in the same amount.

* * * * *

(e) *Core capital limitations.* (1) *Servicing assets and purchased credit card relationships.* (i) The maximum aggregate amount of servicing assets and purchased credit card relationships that may be included in core capital is limited to the lesser of:

(A) 100 percent of the amount of core capital; or

(B) The amount of servicing assets and purchased credit card relationships determined in accordance with paragraph (d) of this section.

(ii) In addition to the aggregate limitation in paragraph (e)(1)(i) of this section, a sublimit applies to purchased credit card relationships and non mortgage-related serving assets. The maximum allowable amount of these two types of assets combined is limited to the lesser of:

(A) 25 percent the amount of core capital; and

(B) The amount of purchased credit card relationships and non mortgage-related servicing assets determined in accordance with paragraph (d) of this section.

(2) *Credit-enhancing interest-only strips.* The maximum aggregate amount of credit-enhancing interest-only strips that may be included in core capital is limited to 25 percent of the amount of core capital. Purchased and retained credit-enhancing interest-only strips, on a non-tax adjusted basis, are included in the total amount that is used for purposes of determining whether a savings association exceeds the core capital limit.

(3) *Computation.* (i) For purposes of computing the limits and sublimit in this paragraph (e), core capital is computed before the deduction of disallowed servicing assets, disallowed credit card relationships, and disallowed credit-enhancing interest-only strips.

(ii) A savings association may elect to deduct disallowed servicing assets and credit-enhancing interest-only strips on a basis that is net of any associated deferred tax liability.

Dated: October 25, 2001.

Ellen Seidman,

Director, Office of Thrift Supervision.

[FR Doc. 01–29179 Filed 11–28–01; 8:45 am]

BILLING CODES 4810–33–P, 6210–01–P, 6714–01–P 6720–01–P