CFO | **CFO Action Item**

Recourse and Residual Capital Rules

Cite

FRB, OCC, FDIC, OTS

Final Rule

Regulatory Capital Treatment of Recourse,

Direct Credit Substitutes, and Residual Interests in Asset Securitization

Recommended Distribution

CFO, Asset Securitization, Mortgage Lending, Credit Card Banks,

Asset/Liability Management, Legal

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Overview

The bank regulators have completed action on a long-pending rule to revise the capital standards applicable to credit risk structures in which a bank takes on recourse, uses a direct credit substitute or holds a residual interest. Consistent with the concern related to residuals in the wake of recent bank failures, the new rule requires dollar-for-dollar capitalization of most residual interests. However, the final rule does not take action on managed assets, a controversial issue raised in the earlier proposal that could have imposed significant costs on credit-card issuers. The rule includes a new ratings-based approach to assessing capital on asset-backed securities (ABS).

Impact

Bank regulators have been struggling with the question of how to capitalize recourse since 1994.[1] Indeed, the Reigle-Neal Act of that year required rules addressing the issue, but regulators still found the complexities raised by structured assets too difficult to resolve until they reached agreement on this rule.[2] Even so, the final rule still leaves some significant issues related to structured financing unresolved. For example, as noted above, the major issue of implicit recourse in managed credit-card receivables is not addressed in this rule. As a result, credit-card issuers will not face a significant capital increase with regard to early-amortization clauses and similar arrangements.

However, credit-card issuers – like all other asset securitizers – could well face significant capital increases resulting from the new rules governing residuals. These include a concentration limit on interest-only (I/O) strips or other interests in which future earnings are capitalized. These interests now can comprise a large percentage of Tier 1 capital, and companies that have relied on them will need to find alternate sources of primary capital. The regulators recognize that the new, stringent treatment of residuals may cause some institutions serious problems, but they believe that the treatment is warranted in light of the valuation and other risks associated with residual interests. These instruments were implicated in several recent high-profile bank failures, including those of Keystone National Bank and Superior FSB.

Although changes to the treatment of residuals will increase capital requirements for affected institutions, the new ratings-based approach to ABS could reduce capital for banks holding high-rated ABS or positions related to them. This could increase the competitiveness of private-label mortgage-backed securities, which now operate at a competitive disadvantage to MBS issued by government-sponsored enterprises. The market for private-label ABS related to other loans could also increase, as could the demand for credit enhancement.

Interestingly, the new flexibility banks have to engage in non-traditional lines of business could reduce the impact of certain aspects of the new rule. Banks facing capital increases because of recourse positions may in some cases be able to convert their credit risk into insurance positions that can be held in insurance, not bank, subsidiaries of their financial holding companies (FHCs). In such cases, the risk would have to be covered by insurance capital standards, which are generally less

[1] See *Financial Services Regulation and Legislation,* May 2, 1994.

[2] See *Financial Services Regulation and Legislation,* August 4, 1994.

onerous. However, the Federal Reserve could take a dim view of companies using their charters for this purpose and impose FHC-level capital to compensate for any reductions.

Consistent with the Basel three-pillar approach to bank regulation, the U.S. regulators are issuing this new capital policy in the context of existing supervisory standards related to asset securitization. The rule cites several recent guidelines on securitization-related issues, including a 1999 restatement of overall supervisory policy on ABS.[3] The capital rules state that institutions not in compliance with the guidelines, especially with regard to residual valuation, will be subject to additional capital requirements, as well as potential enforcement actions. Residual positions are also subject to increased disclosures following various revisions over recent years to bank call reports.

These capital rules generally do not affect ABS or ABS-related interests held in a bank's trading book, which continue to be covered by the market risk rules.[4] However, the concentration limits apply to I/O strips, even if these are held in the trading book. Banks will need to review their positions on a consolidated basis to ensure compliance with the new standard.

Reflecting the importance of securitization in the mortgage arena, the rules and the preamble accompanying them include numerous clarifications related to current mortgage industry practice. These largely safeguard from capital the standard representations and warrantees associated with sales to the secondary market. However, lenders will need to review their practices to ensure that any non-standard agreements are either revised or that additional capital is allocated for them. Second liens or home-equity loans that function as credit enhancements will be considered recourse under the rule, which could subject banks involved in structured mortgage lending (e.g., 80-10-10s) to increased capital for retained second liens.

What's Next

This rule was approved by the FDIC on October 23, 2001. The FRB has approved it by a notational vote, and the OCC and OTS are expected to approve it shortly. This final rule results from numerous earlier

[3] See Client Report RECOURSE, *Financial Services Management*, December 27, 1999.

[4] See *Financial Services Regulation and Legislation,* April 1, 1996.

proposals, including one on recourse issued in February, 2000 and one on residuals issued in September, 2000.[5]

Assuming the rule is published by all of the agencies in November, as anticipated, it will be effective on January 1, 2002. Institutions can recognize capital reductions from the rule for existing assets when the rule is published in the Federal Register, but they need not recognize capital increases related to transactions prior to the effective date until December 31, 2002. All transactions after January 1 will be subject to the new capital standards.

As noted, the final rule does not include a controversial earlier proposal to impose capital on certain revolving securitizations found to have implicit recourse. The OCC strongly opposed this proposal, which would have had a serious and adverse impact on many credit-card banks. The regulators may issue an advance notice of proposed rulemaking to address managed assets, but individual regulators have reserved their right to increase capital related to them through supervisory actions. This suggests that some state-chartered banks could be subject to tougher capital than national banks with regard to these assets unless or until a uniform approach to them is adopted.

Analysis

I. Credit Risk Structures

A. Recourse

The rule for the first time creates a regulatory definition of "recourse," which is any arrangement in which a bank retains, in form or substance, a credit risk in connection with an asset transfer, if the risk exceeds the bank's pro-rata share in the asset. Second liens, in most cases, are not considered recourse. However, a second lien or home-equity loan would be recourse if it functions as a credit enhancement. No clarification is provided as to when this might happen, but second liens do operate as credit enhancements in structured mortgages (e.g., 80-10-10 structures).

Recourse is also generally not deemed to exist when an originator purchases third-party credit enhancement. However, the bank must be completely removed from credit risk to avoid recourse treatment. If the purchase or premium is paid over time and the size of the payment is a

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[5] See Client Report CAPIT56, *Financial Services Management*, February 21, 2000, and Client Report RESIDUAL, *Financial Services Management*, September 5, 2000.

function of the third-party's loss experience, then recourse would be deemed to exist.

B. Direct Credit Substitutes

"Direct credit substitutes (DCS)" are arrangements in which a bank assumes, in form or substance, credit risk associated with an on- or off-balance sheet asset not previously owned by the bank and the risk exceeds the bank's pro-rata share of the asset. It explicitly includes purchased subordinated shares of an interest, agreements to cover credit losses arising from purchased servicing rights, credit derivatives and lines of credit that provide credit enhancement. Some DCS may also be residual interests (see below).

C. Representations and Warrantees

Reps and warrants are common in many asset securitizations, but especially in the mortgage arena. To the extent reps and warrants provide credit risk protection, the rule treats them as recourse or DCS. For example, an agreement to make good any deficiency in appraised value would be considered credit risk and subject to this rule. However, warrants with regard to documentation or other issues create operational, not credit, risk and therefore are not covered by this rule.

The final rule makes it clear that early-default clauses are generally not recourse unless the default period extends longer than 120 days. However, to be eligible for this exclusion, these clauses must cover only residential mortgages eligible for a 50% risk weighting originated within one year of transfer. All other early-default clauses, including those longer than 120 days on qualified mortgages, are considered recourse or DCS.

The final rule continues to treat premium-refund clauses as recourse or DCS, despite adverse comments on this aspect of the proposal. However, an exception has been carved out for premium-refund clauses on government securities and on residential mortgages where the refund rights are limited to 120 days after transfer.

II. Residuals

A. Definition

Residual interests are defined as any on-balance sheet asset that represents an interest, including a beneficial one, created by a transfer that qualifies as a sale under GAAP that exposes the bank to direct or indirect credit risk exceeding the bank's pro-rata share of the asset, whether through subordination or other credit enhancement techniques. These do not include interests purchased from a third party, except for credit-enhancing I/O strips. Examples of residuals include credit-enhancing I/O strips receivable, spread accounts, cash collateral accounts, retained subordinated interests, accrued but uncollected interests on transferred assets available for a credit enhancement, and similar on-balance sheet assets that function as credit enhancements.

This definition is narrower than that in the residual proposal, excluding as it does interests related to financings that are not true sales. However, the agencies remain concerned with financings, and they will monitor them both in aggregate for industry trends and on individual bank books, where more capital may be applied on a case-by-case basis.

B. I/O Strips

The rule includes new, stringent capital standards for credit-enhancing interest-only strips or instruments that function like them as on-balance sheet assets representing contractual rights to receive some or all of the interest income associated with an asset. The rule will apply to both purchased and retained I/O strips, even though purchased ones do not generally now contribute to capital. The rule requires that all I/O strips above 25% of Tier 1 capital be deducted from capital. This concentration limit reflects the agencies' view that capitalized future income is very difficult to value and can be the cause of significant losses, as was the case in the Superior failure.

However, the final rule does not impose the concentration limit on a broader range of residuals, as was initially proposed.

C. Other Residuals

The rule requires dollar-for-dollar capital for unrated residual interests or those with ratings of B or lower, excluding any I/O strips subject to the concentration limit described above. This capital charge could exceed the capital requirement on the asset being transferred, but the agencies believe it is appropriate in light of the significant risks associated with residual interests. Net deferred tax liabilities may be netted against residuals for purposes of this capital calculation, if desired.

Credit derivatives that act like credit enhancements (e.g., credit linked notes) are considered residual interests. Therefore, they are subject to the capital treatment outlined above. The 1999 guidance on synthetic securitizations is reiterated in this capital rule.[6]

[6] See Client Report RECOURSE, *Financial Services Management*, December 27, 1999.

D. Small-Business Loans

Small-business loans in which recourse or residual interests may occur are given separate treatment under the rule with an alternative calculation, consistent with statutory guidance.

III. Asset Securitizations

A. Capital Standards

The new rules include a long-proposed system of setting capital according to the risk of an ABS or ABS-related positions, including recourse, DCS and residuals. The rules retain the ratings-based approach to setting risk-based capital. Traded positions require a rating from only one agency, while untraded ones are subject to more stringent conditions.

The following table summarizes the weightings for long-term positions:

Long-Term Rating Category	Examples	Risk Weight
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 positions are subject to the following treatment, based on the regulators' view that the ratings agencies use a different methodology to set short-term ratings:

Short-Term Rating Category	Examples	Risk Weight
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%

Non-I/O stripped MBS are not eligible for the 20% or 50% weightings noted above.

Positions (other than residuals) that do not qualify for the ratings approach or the others described below must be grossed up. That is, the risk of the unrated position must be aggregated with all more senior positions, subject to the low-level recourse rules. As a result, the grossed-up charge never exceeds that of the underlying asset had it remained on the bank's books. As noted above, residuals are subject to separate, more punitive capital treatment.

Unrated positions that are senior in all respects to rated ones are assumed to have the rating of the highest subordinate position, subject to regulatory approval.

B. Alternative Weightings

The final rule includes three alternatives to reliance on external ratings: internal ratings, ratings agency program ratings, and computer program ratings. However, a floor of 100% is set for capital determined under these alternatives, which means that reliance on this method will not result in any potential improvement over current capital requirements or those that might be obtained through reliance on external ratings. Internal programs may only be used for certain DCS established for commercial paper facilities, but the other alternatives will be more generally available.

Numerous conditions apply to institutions using internal ratings or the other alternatives. The regulators note that they may reevaluate the use of internal systems as the Basel framework, which includes an internal ratings-based approach, is finalized.

C. Clean-Up Calls

Clean-up calls, in which an originator agrees to purchase a specific volume of assets intended for transfer, have long raised supervisory concern that such arrangements function as credit enhancements. Cleanup calls will generally be treated as recourse or DCS. However, a limited exemption has been created for banks that are servicers or affiliated with a loan servicer to purchase no more than 10% of the pool's assets. Loans 30-days or more past-due can be repurchased only if they are purchased at the lower of their book or fair value less accrued interest.

D. Loan Servicing Arrangements

Loan servicing arrangements in which a bank is responsible for credit losses are recourse or DCS. However, cash advances made by residential mortgage servicers to ensure an uninterrupted flow of payments to investors or timely collection are specifically excluded, provided that the servicer is entitled to reimbursement for any significant advances and this reimbursement is not subordinate to other claims. Banks should establish policies on servicer advances, and the capital treatment outlined in this rule is subject to change after the Federal Reserve issues its final standards related to inter-affiliate extensions of credit (Regulation W).[7] Further, supervisory or additional capital standards are possible if examiners believe that the servicing exemption is being abused. ❑

[7] See Client Report REGW, *Financial Services Management*, May 21, 2001.