RB 26 was rescinded 11/29/01 by the Interagency rule on Capital Treatment of Recourse, Direct Credit Substitutes and Residual Interests in Asset Securitizations)

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Capital Requirements on Recourse Arrangements (Interim)

RESCINDED

Summary: This Bulletin sets forth interim guidance for the determination of the capital requirements applicable to certain recourse arrangements. Transactions that result in savings associations remaining liable for losses will not remove their obligation to hold capital. In general, the risk-based capital standard requires savings associations to hold capital against recourse arrangements in an amount equal to the capital requirement on the underlying assets.

As described in this Bulletin, subordinated mortgage-backed securities that meet the definition of high-quality mortgage-related securities are still subject to the capital requirement on recourse arrangements if the savings association remains liable for losses through reimbursement or collateral provisions. In addition, the use of "spread accounts" by savings associations may result in the retention of recourse and savings associations will have to hold capital as required by the capital regulation.

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General Policy

For purposes of determining compliance with the risk-based capital standard for recourse arrangements, the Office of Thrift Supervision (OTS) will look through to the economic substance of the transaction to determine (1) the risk to savings associations and (2) the appropriate capital requirement. *Transactions that result in savings associations remaining liable for losses will not remove their obligation to hold capital.* Examiners should carefully review all recourse arrangements to ensure that savings associations properly calculate their minimum capital requirements. This Bulletin offers interim guidance, pending the outcome of interagency efforts to issue common guidance regulations on recourse.[1]

Under the OTS capital regulation, savings associations must comply with three capital standards: (1) 1.5% tangible capital requirement, (2) 3% (or higher) core capital requirement, and (3) 8% risk-based capital requirement (when fully phased-in). The first two standards are, in general, based on on-balance sheet assets, while the third standard includes not only on-balance sheet assets, but also off-balance sheet items. Off-balance sheet items include recourse arrangements, such as loans sold with recourse.

In general, the risk-based capital standard requires savings associations to hold capital against recourse arrangements in an amount equal to the capital requirement on the underlying assets.

For example, under the risk-based capital standard, a qualifying $100,000 mortgage loan that is risk weighted at 50% requires savings associations to hold $4,000 in capital (when the 8% standard is fully phased-in). If a savings association sold the mortgage loan with 10% recourse (where it would be liable for the first 10%, or $10,000, of losses), the rule would still require the savings association to hold $4,000 in capital. This is because the savings association has retained most of the credit risk associated with the mortgage loan, since it will absorb the "first dollar" losses on the asset. This same principle is applied to a group of mortgages pooled together to create a mortgage-backed security (MBS) with a senior/subordinated structure. Under the rule, the ownership of the subordinated security generally requires savings associations to hold capital against all of the underlying assets that support more senior securities as well as the subordinated security in question because the owner of the subordinated security retains most of the credit risk.

The rule provides an exception to the general requirement on recourse arrangements where the savings association's recourse liability is less than the regular capital requirement on the underlying assets. In such a case, the capital requirement is equal to the recourse amount. For example, if a savings association sells a $100,000 mortgage loan with 1% recourse, it is liable for $1,000 in losses. Instead of requiring it to hold $4,000 in capital, the rule requires the savings association to hold $1,000 in capital. (This same principle applies to subordinated securities.)

Interim Guidance on Specific Transactions

Savings associations will undertake a variety of transactions to remove or reduce the capital requirement and the liability to the savings association from recourse arrangements. If executed properly, these transactions *do* reduce risk to savings associations, and should result in reduced capital requirements. Other transactions, however, will not substantially reduce the risk of loss to savings associations and may not be used to reduce capital requirements. Examiners should review the savings association's documentation for recourse transactions to ensure that it is adequate to support the capital determination and that any recourse liability is reported appropriately.

To ensure a consistent treatment of recourse arrangements by all Federal financial institution regulators, the Federal Deposit Insurance Corporation, Federal Reserve Board, Office of the Comptroller of the Currency, National Credit Union Administration and OTS intend to issue joint guidance on the definition of recourse and appropriate capital requirements. Final regulations implementing this guidance may differ from our current treatment of recourse transactions, including the situations described below. As such, this Bulletin is considered *interim* in nature, subject to change based on the final interagency guidance.

We recognize that this Bulletin (and the OTS capital regulation) does not take into account all issues surrounding recourse arrangements (i.e., certain tax effects associated with asset sales). Such issues will be resolved as part of the inter-agency guidance described above.

1. **Certain subordinated mortgage-backed securities that meet the definition of high quality mortgage-related securities (as defined in 5 C.F.R. 567.1 (k)) are *still* subject to the capital requirements on recourse arrangements.**

Savings associations may take actions to qualify subordinated mortgage-backed securities as high quality mortgage-related securities. Such action will reduce the capital requirement on the subordinated mortgage-backed securities *provided* that such actions do not involve recourse to the savings association.

For example, if, to qualify as high quality mortgage-related securities, the savings association pays a fee (that does not adjust due to losses incurred) to an insurer or issuer of a letter of credit, the savings association may place the subordinated mortgage-backed security in the 20% risk-weight category if the association eliminates all of its risk exposure to credit loss from the underlying assets. This could occur, for example, if the insurance policy clearly provides that the savings association as the holder of a $10 million subordinated mortgage-backed security will receive $10 million regardless of losses on the underlying mortgages.

If, however, the savings association, to meet the requirements of high quality mortgage-related securities, relies on a third party letter of credit (or other guarantee) that requires the savings association to agree to "reimbursement" provisions or to collateralize assets (where, in either case, the savings association remains liable for any losses), the transaction would *not* reduce a savings association's capital requirement, as it remains liable for losses.

2. **The use of "spread accounts" requires savings associations to capitalize any expected gains or losses booked under the transaction.**

Savings associations may use spread accounts to reduce the potential liability from recourse arrangements. In a spread account, a savings association would, for example, take $100 million in mortgage loans and move them into a separate trust. The trust would issue an MBS. The association would retain a "residual" interest in the trust.

Traditionally, spread accounts have been used for credit card receivables, where, for example, the receivables yield 18% and the securities pay a rate of 12%. The difference — 6% — is referred to as the "spread." The spread, or a portion thereof, is accumulated in the trust account and used to ensure payment to the security holders. Once the securities have all been paid off (i.e., if 2 year securities, at the end of the second year), any remaining funds in the spread account would revert to the association.

Generally accepted accounting principles (GAAP) generally require institutions to record the present value of any "excess future servicing income" (including the portion designated as spread) as an asset. Recording the present value of this excess future servicing income as an asset results in an increase in the gain or a reduction of the loss on sale of the underlying mortgages.

Savings associations that record an asset and report gains under GAAP that includes the spread have effectively retained recourse on the transaction, (i.e., the savings association has retained the risk of loss associated with the assets sold). As a result, savings associations must hold capital against the underlying assets in the trust, with a maximum capital charge equal to the amount at risk (i.e., the asset recorded that relates to the present value of the spread account).

For example, assume a savings association recorded an asset that related to excess future servicing income of $500,000, and this amount is less than the capital requirement on the assets transferred to the trust. In this scenario, the capital charge would equal $500,000. Further, if only a portion of the recorded excess future servicing income relates to the present value of the spread account, the capital charge would be equal to that portion. For example, if a savings association recorded excess future servicing income of 50 basis points and only 30 basis points of the 50 basis points is to be used to fund the spread account, the maximum capital charge equals the portion of the asset recorded related to the 30 basis points.

The capital charge for the "spread" portion of the transaction is also limited (to the extent applicable) to the gross cumulative amount required to be transferred to the spread account over the life of the spread account *if* the asset recorded is a greater amount than the gross cumulative required transfers.

If a savings association does not record any excess future servicing income that relates to the spread account, the association has not retained any risk of loss associated with the assets sold. As a result, no capital charge will be imposed that relates to the assets transferred to the trust.

If a savings association provides initial funding to the trust account in addition to the "spread," this initial funding is at risk and must be added (dollar-for-dollar) to the capital charge from the "spread" portion of the transaction.

3. **Savings associations that repackage subordinated mortgage-backed securities must hold capital against the risk of such securities.**

Savings associations may take mortgage loans, create several senior/subordinated MBS, retain the subordinated mortgage-backed securities and then *repackage* the subordinated securities into a new senior/subordinated security. This new senior/subordinated security would have as the underlying assets *only* subordinated mortgage-backed securities. (For example, a savings association that owns 10 $10 million pools of mortgage loans creates 10 senior/subordinated mortgage-backed securities, each with a $9 million senior security and a $1 million subordinated security. The 10 $9 million senior securities are sold to third parties. The 10 $1 million subordinated securities are repackaged into a new $10 million security, with a new $9 senior security and a $1 million subordinated security.)

Savings associations that own either the senior or the subordinated portion of this *new* repackaged senior/subordinated MBS must hold capital against the *full* amount of the underlying assets (mortgage loans), with a maximum capital charge equal to the amount of the asset owned. (In the example above, associations owning the $9 million new senior security would be required to hold capital against $99 million; associations owning the $1 million new subordinated security would be required to fully capitalize the $1 million.)

The only exception to this requirement is where the new senior security qualifies as a high quality mortgage-related security. If it does, the new senior security is placed in the 20% risk-weight category, subject to the limitations described under situation #1 (above) on the ability of securities to be considered high quality mortgage-related securities due to recourse.

4. **Savings associations that use investment companies to remove subordinated mortgage-backed securities from their balance sheet must hold capital against the risk of such investments.**

Savings associations may exchange their subordinated securities for shares of an investment company (or sell them to an investment company and invest the proceeds in shares of the investment company).

The risk-based capital requirement for investment companies (mutual funds) is determined by the assets held by the mutual fund. (The asset of the mutual fund with the highest capital requirement under our regulation, in general, determines the savings association's capital requirement on the investment in the mutual fund.) In this instance, the savings association's capital requirement would be determined by the capital requirement on subordinated securities. This effectively imposes the same capital requirement as though the savings association held the subordinated securities on its balance sheet.

5. **Savings associations that sell assets where there is recourse to their holding companies may not be subject to the capi-**

tal requirement on assets sold with recourse provided certain conditions are met.

Savings associations may undertake transactions where they sell assets with recourse where the recourse would be to their holding companies, rather than to the savings associations.

This is an acceptable method to remove the capital requirement on the loans sold, provided (i) there is proper documentation of non-recourse to the savings association, (ii) the holding company has substantial additional resources (besides a savings association) with which it could fulfill its recourse obligation, and (iii) the savings association discloses that the purchaser has no recourse to the savings association under any circumstances. Further, the savings association's subsequent behavior must support the non-recourse provisions.

[1] As with all novel transactions and investments, institutions must ensure that such activities are permissible under applicable laws, regulations and OTS policy.

— *Jonathan L. Fiechter*