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## CAPITAL TREATMENT FOR RECOURSE, DIRECT CREDIT SUBSTITUTES, AND RESIDUAL INTERESTS

On November 29, 2001, OTS and the other federal banking agencies issued a new capital rule for recourse, direct credit substitutes, and residual interests in asset securitizations. The new capital rule addresses many aspects of risk resulting from asset securitization. While it integrates some aspects of OTS's existing capital rules and guidance for recourse and direct credit substitutes, the new rule is far more extensive because of a very complex, evolving securitization marketplace. This Appendix outlines and highlights some aspects of the rule that pertain to securitizations. However, because of the complex nature of the rule, you should also refer to the rule itself and its extensive preamble published in the Federal Register, both of which are available on the OTS web site.

In addition, you can find the definitions pertaining to the new rule along with other terms used in the OTS capital regulations in 12 CFR §567.1, and the capital treatment from the new rule in §567.6(b). Refer also to CEO Letter No. 162, "Implicit Recourse in Asset Securitizations," and to CEO Letter No. 163, "Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations." These CEO letters, issued by OTS on May 23, 2002, provide important supplementary information.

You should also note that through the rule's reservation of authority, OTS will look to the substance of a transaction regardless of how the allocation of risk is categorized by others. OTS may find that the proposed capital treatment by the thrift does not appropriately reflect risk to the institution. OTS may then require the thrift to apply another risk weight, conversion factor, or treatment that OTS deems appropriate.

### Recourse, In General

The term "recourse" refers to an institution's retention, in form or in substance, of any credit risk directly or indirectly associated with an asset it has sold. A recourse obligation typically arises when an institution transfers an asset in a sale (a sale according to generally accepted accounting principles) and retains an obligation to repurchase the asset or to otherwise absorb losses on the asset. Examples of recourse obligations include:

- Assets sold under an agreement to repurchase.
- Credit-enhancing representations and warranties related to sold assets.
- Retained loan servicing with an agreement under which the savings association is responsible for losses associated with the loans serviced (except for Servicer Cash Advances as defined in §567.1).
- Clean-up calls on assets sold (except for 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).

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- Credit derivatives that absorb more than the savings association's pro rata share of losses on transferred assets.
  - Loan strips sold where the maturity of the transferred portion of the loan is shorter than the commitment under which the loan is drawn.

Recourse can also exist implicitly. Implicit recourse generally arises when a thrift institution repurchases assets, absorbs losses, or otherwise supports assets that it has sold, in instances where it is not contractually required to do so. Refer also to CEO Letter No. 162.

As with other off-balance-sheet exposures, you must convert a recourse exposure to an on-balance-sheet asset by obtaining a credit equivalent amount. In the case of a simple loan sale with recourse, which may or may not involve asset securitization, you convert the entire balance of the loans sold to an on-balance-sheet asset using the 100 percent conversion factor. (For information about converting off-balance-sheet assets to on-balance-sheet assets using conversion factors, refer to §567.6(a)(2), as well as the Thrift Financial Report Instruction Manual.)

In many instances, an institution retains a recourse exposure that is limited in dollar amount or as a percentage of assets transferred, but is designed to absorb the first losses that occur for the entire pool of transferred assets. The recourse exposure thus absorbs more than its pro rata share of losses. As a result, the general capital treatment for most recourse exposures is "gross-up," whereby the institution must hold capital for the full amount of the transferred assets as if they were still on the balance sheet. OTS applies this relatively rigorous capital treatment because the recourse exposure receives more than its pro rata share of risk; it has the concentrated risk of all of the assets senior to it in the pool.

Therefore, using the required gross-up approach you obtain the credit equivalent amount by multiplying the full amount of the credit-enhanced assets for which the savings institution directly or indirectly retains or assumes credit risk by a 100 percent conversion factor. You 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. However:

- A thrift institution does not have to hold recourse capital for Qualifying 1-4 Family Loans that a thrift institution has sold, if the sales contract allows only a 120-day period for return of those loans. The loans must have been originated within one year before sale. This exception would apply to a simple loan sale as well as a sale of loans into a securitization.
- There is an exception to the gross-up treatment for low-level recourse exposures where recourse is legally and contractually limited to an amount less than the on-balance-sheet capital requirement. OTS limits the capital requirement to the maximum exposure rather than the full capital charge.
- A ratings based approach allows an institution to reduce its capital requirement for lower-risk, highly rated recourse exposures – Section C below.

*Example: Recourse Sale of Loans*

Thrift has sold \$100 in Qualifying 1-4 Family (that is, 50 percent risk weight) Loans into a securitization with an agreement to repurchase them for up to 180 days: Capital requirement (until the recourse period expires) is:  $(\$100) \times (100\% \text{ conversion factor}) \times (50\% \text{ r.w.}) \times (8\%) = \$4$

*Note:* If the sales agreement limited the recourse to 120 days or less, there would be no capital requirement.

When a thrift's recourse exposure is in a "first loss" or other subordinated position, the thrift must gross-up the entire pool above it (all the more senior exposure), before converting it to an on-balance-sheet credit equivalent amount. However, the ratings-based approach can apply (see Ratings-Based Approach Section).

*Example: Recourse Sale with a First Loss Position Using Gross-up*

An institution has retained the "1st dollar loss" subordinated interest of \$5 in a securitization of \$100 in Qualifying 1-4 Family Loans. Capital requirement is  $(\$100) \times (50\% \text{ r.w.}) \times (8\%) = \$4$ . That is, the thrift must gross-up its exposure to include all exposures that are more senior to the piece that the thrift owns (in this case the entire pool). This example assumes that the first dollar loss position is not a credit-enhancing IO Strip (See Residual Interests Section below).

*Example: Low-Level Recourse*

An institution contractually limits its maximum recourse exposure to less than the normal on-balance-sheet capital requirement for the assets sold with recourse. For example, if an institution sells a \$100,000 mortgage loan with 1 percent recourse, it is liable for \$1,000 in losses. Instead of requiring the savings association to hold \$4,000 in capital (assuming the loan qualifies for 50 percent risk weight), OTS requires the institution hold \$1,000 in capital, the maximum recourse exposure.

## Direct Credit Substitutes

An institution can guaranty, purchase, or assume a recourse exposure from another organization. We generally refer to these exposures as direct credit substitutes. A purchased subordinated security is an example of a direct credit substitute. Direct credit substitutes can be on- or off-balance-sheet. Examples of such direct credit substitutes include:

- Financial standby letters of credit that support financial claims on a third party that exceed the savings institution's pro rata share of the financial claim.
- Purchased subordinated interests that absorb more than their pro rata share of losses from the underlying assets.

When a thrift purchases a subordinated asset-backed security or similar interest, the thrift generally must gross-up the risk exposure in order to determine the capital requirement. This means that the thrift must hold capital against the total amount of the subordinated security plus all assets senior to it. However, the low-level recourse rule can apply to direct credit substitutes, and the ratings-based approach may apply (see Ratings-Based Approach Section below).

*Example: Direct Credit Substitute – Purchased Subordinated Interest*

An institution has purchased the “1st dollar loss” subordinated interest of \$5 in a securitization of \$100 in Qualifying 1-4 Family Loans. Capital requirement is  $(\$100) \times (50\% \text{ r.w.}) \times (8\%) = \$4$ . That is, the thrift must gross-up its exposure to include all exposures that are more senior to the security that the thrift owns (in this case the entire pool). This example assumes that the first dollar loss position is not a credit-enhancing IO Strip (See Residual Interests Section below).

### Capital Treatment for Residual Interests

Residual interests are on-balance-sheet risk exposures arising from sales (transfers) of financial assets that expose a thrift to credit risk on those transferred assets that exceeds a pro rata share of any claim that the thrift has on the assets. Residual interests do not include interests purchased from a third party, except for credit-enhancing interest-only strips (see below). A primary example of a residual is a retained subordinated interest on assets formerly owned by the institution.

The standard capital treatment for most residual interests is dollar-for-dollar. That is, the thrift must hold one dollar in capital for every one dollar in residual interests.

*Example: Residual Interests*

An institution has retained the “first dollar loss” subordinated interest of \$15 in its own securitization of \$100 in Qualifying 1-4 Family Loans. The risk based capital requirement is \$15. (That is, \$1 of capital for \$1 of residual interests – dollar-for-dollar capital.)

There are two approaches to reporting dollar-for-dollar capital on the TFR:

- The super risk-weight approach, where you multiply the asset balance by 12.5, before risk weighting it. Because 12.5 is the reciprocal of 8 percent, after multiplying the asset by the 8 percent risk-based capital requirement, the result is dollar-for-dollar capital.
- The simplified method, where you deduct the exposure from total capital.

### Credit-Enhancing Interest-Only Strips

Credit-enhancing interest-only strips (IOs), whether retained or purchased, pose higher risk than most other residuals. If a thrift has a concentration of more than 25 percent of Tier One Capital in IOs, it must deduct from Tier One Capital, the portion of IOs that exceeds 25 percent of Tier 1 Capital.

*Example: Credit-Enhancing IO Strip*

The institution has the “1st dollar loss” subordinated interest (whether retained or purchased) that is a credit-enhancing IO strip, of \$15 in a securitization of subprime auto loans. Core Capital is \$40 at onset. The thrift does not have any other IOs.

1. 25% of \$40 is \$10. \$15 exceeds \$10 by \$5, so you deduct \$5 from Core Capital.
2. New Core Capital is \$35.

3. The institution must also hold \$10 in Risk-Based Capital for this exposure because you deduct the same amount, \$5, as above from the IO strip. The thrift must hold dollar-for-dollar risk-based capital against the remaining balance.

### The Ratings-Based Approach

The ratings-based approach allows for the possibility of a lower risk-based capital requirement (reflecting less risk) for certain recourse, direct credit substitutes, and residual interests arising from asset securitization. Ratings must be from one or more Nationally Recognized Statistical Rating Organizations (NRSROs). (See §567.1, i.e. Standard & Poors, Moody's, and Fitch Ratings.)

There are exceptions:

- Credit-enhancing IO strips are not eligible for the Ratings-Based Approach.
- Bonds not in security form are not eligible.
- Bonds not backed by assets are not eligible.

In general, the following schedule applies to long-term ratings:

<b><i>Long-Term Rating Category</i></b>	<b><i>Examples</i></b>	<b><i>Risk Weight</i></b>
<i>Highest or second highest investment grade.....</i>	<i>AAA or AA</i>	<i>20%</i>
<i>Third highest investment grade.....</i>	<i>A</i>	<i>50%</i>
<i>Lowest investment grade ....</i>	<i>BBB</i>	<i>100%</i>
<i>One category below investment grade.....</i>	<i>BB</i>	<i>200%</i>
<i>More than one category below investment grade, or unrated.....</i>	<i>B or unrated</i>	<i>Not eligible for ratings-based approach.</i>

Note: There is also a separate short-term rating table. Refer to the regulations.

The Ratings-Based Approach makes a distinction between “traded” and “nontraded” positions. Nontraded positions require the following:

- An external rating by more than one NRSRO
- Minimum rating assigned by each NRSRO that meets all of the following:
  1. Long Term: At least one category below investment grade.
  2. Short Term: Investment Grade.
  3. Rating must be publicly available.
  4. Rating must be based on the same criteria as for traded positions.

*Note:* The capital regulations allow for use of a thrift’s internal ratings in limited circumstances after initial and ongoing OTS approval. The thrift must use software and ratings that correspond credibly and reliably to the NRSRO ratings.

### Program Ratings

Program Ratings can be used for certain risk exposures in specific secondary market loan programs. A thrift may make use of program ratings after OTS has reviewed the nature of the program and accepts, under specific conditions, a rating assigned to a particular risk exposure that the thrift retains. The rating must correspond credibly and reliably with an NRSRO rating.