

Office of Thrift Supervision

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Handbook: Thrift Activities
Subjects: Capital Adequacy

Section: 320
TB 38

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Guidelines For Capital Requirements On Collateralized
Mortgage Obligations

RESCINDED

Summary: For purposes of the Risk-Based Capital Standard, certain classes of CMO tranches are deemed to exhibit excessive interest-rate, prepayment-rate or principal loss risk, and are assigned to the 100% risk-weight category.

For Further Information Contact: Your District Office or the Supervision Policy Division of OTS, Washington, D.C.

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Purpose:

This Bulletin provides guidance concerning the appropriate capital requirement on CMO tranches.

Background:

Section 301 of the Financial Institutions Reform, Recovery, and Enforcement Act, Pub. L. No. 101-73, 103 Stat. 183 (Aug. 9, 1989), amends the Home Owners' Loan Act of 1933 to require the OTS to promulgate a risk-based capital regulation. The OTS has recently issued its risk-based capital regulation. See 54 Fed. Reg. 46845 (Nov. 8, 1989).

Under the new risk-based capital regulation, certain mortgage-related securities are assigned to the 20% risk-weight category. 12 C.F.R. 567.6(a)(1)(ii)(H). The mortgage-related securities that qualify for assignment to the 20% risk-weight category are high quality mortgage-related securities, except for stripped mortgage-related securities and those classes with residual characteristics.

High quality mortgage-related securities include, for purposes of the risk-based capital regulation, mortgage-related securities as

defined in section 3(a)(41) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(41), and those securities issued by or fully-guaranteed by the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Government National Mortgage Association. 12 C.F.R. 567.1(k).

Collateralized mortgage obligations ("CMOs") are a type of mortgage-related security; CMOs include obligations collateralized by securities issued by or fully-guaranteed by the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Government National Mortgage Association. CMOs are multiclass securities (i.e., typically composed of different tranches). Interest-rate, prepayment-rate and principal loss risk vary significantly depending on the features of a particular tranche. Tranches that meet the definition of high quality mortgage-related securities are generally assigned to the 20% risk-weight category. As set forth more fully below, however, certain CMOs tranches are assigned to the 100% risk-weight category.

As stated in the risk-based capital regulation, 12 C.F.R. 567.6(a)(1)(ii)(H), one exception to the assignment to the 20% risk-weight category is made for classes of high quality mortgage-related securities with residual characteristics. As defined in the regulation, 12 C.F.R. 567.1(aa), the term "residual characteristics" means interests similar to a multi-

class pay-through obligation representing the excess cash flow generated from mortgage collateral over the amount required for the issue's debt service and ongoing administrative expenses or interests presenting similar degrees of interest-rate/prepayment risk and principal loss risk.

Clarification Of The Treatment Of CMO Tranches

The Office, after a review of currently existing CMO tranches, has determined that certain classes of CMO tranches (listed below) represent interests that present sufficiently high degrees of interest-rate/prepayment risk or principal loss risk to warrant their exclusion from the 20% risk-weight category. One basis for the Office's determination is the relative degree of interest rate sensitivity such tranches exhibit, compared to non-stripped, fixed-rate, current coupon, 30-year mortgage-backed securities.

The classes of CMO tranches listed below are deemed to have residual characteristics and, pursuant to 12 C.F.R. 567.6(a)(1)(ii)(H) and 567.6(a)(1)(iv)(N), are assigned to the 100% risk-weight category. This list is in addition to those classes of CMO tranches that are in the 100% risk-weight category because they do not meet the requirement of section 3(a)(41) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(41), or are not collateralized by securities issued by or fully-guaranteed by the

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Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or the Government National Mortgage Association.

For purposes of the risk-based capital rule, multiclass instruments issued by Real Estate Mortgage Investment Conduits (REMICs) will be treated similar to CMOs.

The Office reserves the right to review classes of CMOs and may make revisions to the list below, as appropriate. The risk-weight category that CMOs are assigned to will be reviewed for appropriateness

upon adoption of an interest rate risk component to the Office's risk-based capital rule. At that time, the Office intends to separate the minimum capital requirement that results from interest-rate/prepayment risk from the requirement that results from credit risk under the current risk-weighting arrangement.

CMO Tranches That Are Deemed To Have Residual Characteristics For Purposes Of The Risk-Based Capital Regulation

- Fixed-rate Residuals
- Super Principal-Only (Super POs)

- Floating-rate Residuals
- Inverse Floaters
- Z-tranches
- Fixed-rate Planned Amortization Class (PAC) support tranches with weighted-average lives at issuance in excess of 7 years
- Fixed-rate Targeted Amortization Class (TAC) support tranches with weighted-average lives at issuance in excess of 7 years



— John F. Robinson
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