

**Examples of Reporting an On-Balance Sheet Security
That is a Direct Credit Substitute
Not Eligible for the Ratings-Based Approach
in Call Report Schedule RC-R – Regulatory Capital**

A direct credit substitute is “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.” A purchased subordinated security in a securitization or structured finance program, as defined in the agencies’ risk-based capital standards, is a direct credit substitute. Examples of such direct credit substitutes include, but are not limited to, the mezzanine and subordinate tranches of private-label mortgage-backed securities and collateralized debt obligations. A so-called senior tranche of a securitization or structured finance program (hereafter referred to collectively as a securitization) is not a direct credit substitute provided it cannot absorb credit losses prior to another designated senior tranche.

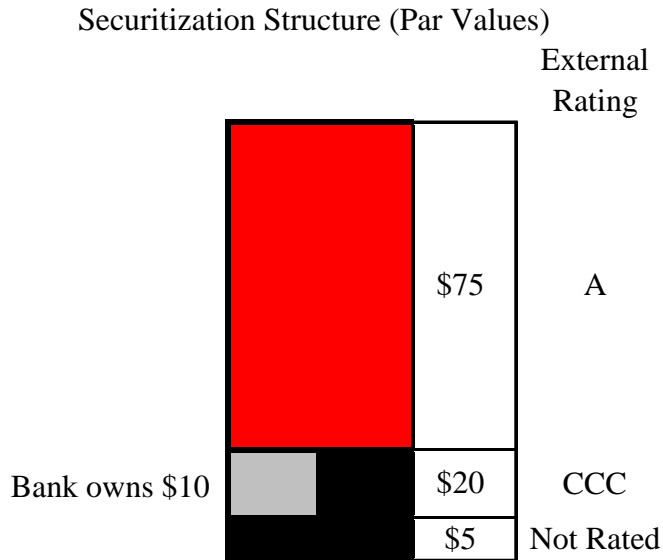
If a purchased subordinated security is rated more than one category below investment grade (e.g., below BB-) or unrated, the security is not eligible for the ratings-based approach set forth in the agencies’ risk-based capital standards. In this situation, or if a bank elects not to use the ratings-based approach for an eligible purchased subordinated security, the risk-weighted asset calculation for the security is based on the “face amount” of the bank’s purchased subordinated security¹ plus the pro rata portion of all the more senior positions currently outstanding in the securitization that the bank’s security supports. If the resulting risk-based capital requirement for the purchased subordinated security (i.e., the sum of the “face amount” and the pro rata portion of the more senior positions, multiplied by the risk weight applicable to the security, multiplied by 8 percent) is greater than the face amount of the security, the low-level exposure rule would apply to the security. The low-level exposure rule in effect imposes a dollar-for-dollar capital requirement on the purchased subordinated security.

The following examples supplement the instructions for the “Treatment of Purchased Subordinated Securities That Are Direct Credit Substitutes Not Eligible for the Ratings-Based Approach” on pages RC-R-17 through RC-R-18b (dated 3-09) of the Call Report instructions by illustrating the approach banks should follow to determine whether the low-level exposure rule applies to a purchased subordinated security not eligible for the ratings-based approach. The examples also show how banks should report such a purchased subordinated security for risk-based capital purposes in Call Report Schedule RC-R – Regulatory Capital when the low-level exposure rule does not apply to the security and when the low-level exposure rule does apply to the security.

¹ For risk-based capital purposes, the “face amount” of an available-for-sale security and a held-to-maturity security is its amortized cost; the “face amount” of a trading security is its fair value.

Low-Level Exposure Rule Does Not Apply

A bank holds a \$10 par value interest in the mezzanine security in the \$100 asset-backed security structure shown below that is comprised of a \$75 par value senior tranche, a \$20 par value mezzanine tranche, and a \$5 par value equity or first loss tranche.² The assets underlying the asset-backed security structure are subject to a 100 percent risk weight. Although the securities in the senior and mezzanine tranches were originally rated AAA and BBB when the bank purchased its interest in the mezzanine security, both tranches have been downgraded to ratings of A and CCC, respectively. The mezzanine security would no longer be eligible for the ratings-based approach because it is rated below BB-. The bank would have to use the pro rata gross-up treatment to calculate the risk-weighted asset amount for the mezzanine security and determine whether the low-level exposure rule applies.



Case I: Bank's Investment in the Mezzanine Security is Available-for-Sale (AFS) or Held-to-Maturity (HTM) and its Amortized Cost is \$9.50

The risk-weighted asset amount for the bank's investment in the mezzanine security, in which it holds a 50 percent interest, is determined as follows:

² The par values shown for the security are the currently outstanding par values as of the Call Report date, not the original par values when the security was issued.

(a) Percentage share of the total currently outstanding par value of the mezzanine tranche owned by the bank (\$10/\$20)		50%
(b) Currently outstanding par value of the more senior positions supported by the mezzanine tranche		\$75
(c) Bank's percentage share of the mezzanine tranche multiplied by currently outstanding par value of the more senior positions supported by the mezzanine tranche [(a) * (b)]	=	\$37.50
(d) "Face amount" of the bank's purchased subordinated security (amortized cost)	+	\$9.50
(e) Sum of the "face amount" of the bank's purchased subordinated security and the pro rata share of the more senior positions supported by the mezzanine tranche [(c) + (d)]	=	\$47.00
(f) Multiply the sum by the appropriate risk weight of the underlying assets	x	100%
(g) Risk-weighted asset amount for the bank's share of the mezzanine tranche [(e) * (f)]	=	\$47.00
(h) Capital charge for the risk-weighted asset amount [.08 * (g)]	=	\$3.76
(i) Check for applicability of the low-level exposure rule: Is the capital charge for the risk-weighted asset amount greater than the bank's maximum contractual exposure on its investment (the "face amount" of the bank's investment in the mezzanine tranche), i.e., is (h) greater than (d)? If yes, the low-level exposure rule applies. If no, the low-level exposure rule does not apply; instead, the pro rata gross-up treatment applies.		No

Reporting in Schedule RC-R:

Case IA: Bank's Investment in the Mezzanine Tranche is an AFS Security

Assume the fair value of the bank's investment is \$4.00 and its amortized cost is \$9.50. Assume that the bank properly documents and supports that the \$5.50 unrealized loss on this AFS security is a temporary impairment, and the unrealized loss is reported, net of tax effect, on the Call Report balance sheet in Schedule RC, item 26.b, "Accumulated other comprehensive income." The \$4.00 fair value of this investment is included on the Call Report balance sheet in Schedule RC, item 2.b, "Available-for-sale securities," and on the regulatory capital schedule in column A of Schedule RC-R, item 36, "Available-for-sale securities." Because AFS securities are risk-weighted using their amortized cost rather than their fair value, the gross unrealized loss of \$5.50 on the bank's investment in the mezzanine security is reported as a negative number in column B of Schedule RC-R, item 36, "Available-for-sale securities." In addition, because the mezzanine security is subject to the pro rata gross-up treatment for risk-based capital purposes, the bank's pro rata share of the more senior positions supported by the mezzanine tranche is also subject to risk-weighting, which is \$37.50 from above. The bank must report this \$37.50 as a negative number in column B of Schedule RC-R, item 36, "Available-for-sale securities." Because the assets underlying the asset-backed security structure are subject to a 100 percent risk weight, the bank must include \$47.00 (\$9.50 amortized cost plus \$37.50 pro rata share of the more senior positions) in column F, "100%," of Schedule RC-R, item 36, "Available-for-sale securities." This will ensure that the amount reported in item 36, column A, for the bank's AFS investment (\$4.00) equals the sum of columns B through F [(-\$5.50) + (-\$37.50) + 47.00].

	Column A	Column B	Column F
	Totals	Items Not Subject to Risk-Weighting	100%
36 Available-for-sale securities	\$4.00	[(-\$5.50) + (-\$37.50)]	\$47.00

Case II: Bank’s Investment in the Mezzanine Tranche is an HTM Security

Assume the amortized cost of the bank’s investment is \$9.50 and its fair value is \$4.00. Assume the bank properly documents and supports that the \$5.50 unrealized loss on this HTM security is a temporary impairment, which is not reflected on the balance sheet. The \$9.50 amortized cost of this investment is included on the Call Report balance sheet in Schedule RC, item 2.a, “Held-to-maturity securities,” and on the regulatory capital schedule in column A of Schedule RC-R, item 35, “Held-to-maturity securities.” Because the mezzanine security is subject to the pro rata gross-up treatment for risk-based capital purposes, the bank’s pro rata share of the more senior positions supported by the mezzanine tranche is also subject to risk-weighting, which is \$37.50 from above. The bank must report this \$37.50 as a negative number in column B of Schedule RC-R, item 35, “Held-to-maturity securities.” Because the assets underlying the asset-backed security structure are subject to a 100 percent risk weight, the bank must include \$47.00 (\$9.50 amortized cost plus \$37.50 pro rata share of the more senior positions) in column F, “100%,” of Schedule RC-R, item 35, “Held-to-maturity securities.” This will ensure that the amount reported in item 35, column A, for the bank’s HTM investment (\$9.50) equals the sum of columns B through F [(-\$37.50) + 47.00].

	Column A	Column B	Column F
	Totals	Items Not Subject to Risk-Weighting	100%
35 Held-to-maturity securities	\$9.50	-\$37.50	\$47.00

Case II: Bank’s Investment in the Mezzanine Security is a Trading Security and its Fair Value is \$4.00 (Bank is Not Subject to the Market Risk Capital Requirement)

The risk-weighted asset amount for the bank’s investment in the mezzanine security, in which it holds a 50 percent interest, is determined as follows:

(a) Percentage share of the total currently outstanding par value of the mezzanine tranche owned by the bank (\$10/\$20)		50%
(b) Currently outstanding par value of the more senior positions supported by the mezzanine tranche		\$75
(c) Bank’s percentage share of the mezzanine tranche multiplied by currently outstanding par value of the more senior positions supported by the mezzanine tranche [(a) * (b)]	=	\$37.50
(d) “Face amount” of the bank’s purchased subordinated security (fair value)	+	\$4.00
(e) Sum of the “face amount” of the bank’s purchased subordinated security and the pro rata share of the more senior positions supported by the mezzanine tranche [(c) + (d)]	=	\$41.50

(f) Multiply the sum by the appropriate risk weight of the underlying assets	x	100%
(g) Risk-weighted asset amount for the bank’s share of the mezzanine tranche [(e) * (f)]	=	\$41.50
(h) Capital charge for the risk-weighted asset amount [.08 * (g)]	=	\$3.32
(i) Check for applicability of the low-level exposure rule: Is the capital charge for the risk-weighted asset amount greater than the bank’s maximum contractual exposure on its investment (the “face amount” of the bank’s investment in the mezzanine tranche), i.e., is (h) greater than (d)? If yes, the low-level exposure rule applies. If no, the low-level exposure rule does not apply; instead, the pro rata gross-up treatment applies.		No

Reporting in Schedule RC-R:

The fair value of the bank’s investment is \$4.00. This \$4.00 fair value is included on the Call Report balance sheet in Schedule RC, item 5, “Trading assets,” and on the regulatory capital schedule in column A of Schedule RC-R, item 41, “Trading assets.” Because the mezzanine security is subject to the pro rata gross-up treatment for risk-based capital purposes, the bank’s pro rata share of the more senior positions supported by the mezzanine tranche is also subject to risk-weighting, which is \$37.50 from above. The bank must report this \$37.50 as a negative number in column B of Schedule RC-R, item 41, “Trading assets.” Because the assets underlying the asset-backed security structure are subject to a 100 percent risk weight, the bank must include \$41.50 (\$4.00 fair value plus \$37.50 pro rata share of the more senior positions) in column F, “100%,” of Schedule RC-R, item 41, “Trading assets.” This will ensure that the amount reported in item 41, column A, for the bank’s trading asset (\$4.00) equals the sum of columns B through F [(-\$37.50) + 41.50].

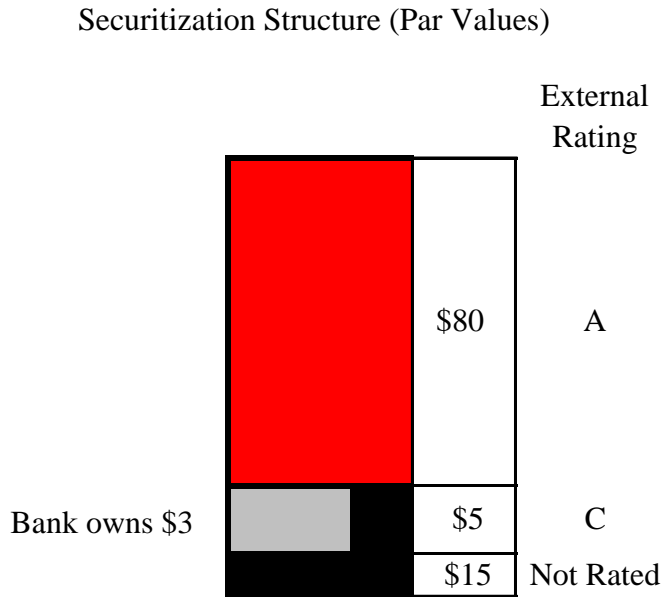
	Column A	Column B	Column F
	Totals	Items Not Subject to Risk-Weighting	100%
41 Trading Assets	\$4.00	-\$37.50	\$41.50

Low-Level Exposure Rule Applies

A bank holds a \$3 par value interest in the mezzanine security in the \$100 asset-backed security structure shown below that is comprised of an \$80 par value senior tranche, a \$5 par value mezzanine tranche, and a \$15 par value equity or first loss tranche.³ The assets underlying the asset-backed security structure are subject to a 100 percent risk weight. Although the securities in the senior and mezzanine tranches were originally rated AAA and A when the bank purchased its interest in the mezzanine security, both tranches have been downgraded to ratings of A and C, respectively. The mezzanine security would no longer be eligible for the ratings-based approach because it is rated below BB-. The bank would have to use the pro rata gross-up treatment to

³ The par values shown for the security are the currently outstanding par values as of the Call Report date, not the original par values when the security was issued.

calculate the risk-weighted asset amount for the mezzanine security and determine whether the low-level exposure rule applies.



Case III: Bank’s Investment in the Mezzanine Security is AFS or HTM and its Amortized Cost is \$2.75

The risk-weighted asset amount for the bank’s investment in the mezzanine security, in which it holds a 60 percent interest, is determined as follows:

(a) Percentage share of the total currently outstanding par value of the mezzanine tranche owned by the bank (\$3/\$5)		60%
(b) Currently outstanding par value of the more senior positions supported by the mezzanine tranche		\$80
(c) Bank’s percentage share of the mezzanine tranche multiplied by currently outstanding par value of the more senior positions supported by the mezzanine tranche [(a) *(b)]	=	\$48.00
(d) “Face amount” of the bank’s purchased subordinated security (amortized cost)	+	\$2.75
(e) Sum of the “face amount” of the bank’s purchased subordinated security and the pro rata share of the more senior positions supported by the mezzanine tranche [(c) + (d)]	=	\$50.75
(f) Multiply the sum by the appropriate risk weight of the underlying assets	x	100%
(g) Risk-weighted asset amount for the bank’s share of the mezzanine tranche [(e) * (f)]	=	\$50.75
(h) Capital charge for the risk-weighted asset amount [.08 * (g)]	=	\$4.06
(i) Check for applicability of the low-level exposure rule: Is the capital charge for the risk-weighted asset amount greater than the bank’s maximum contractual exposure on its investment (the “face amount” of the bank’s investment in the mezzanine tranche), i.e., is (h) greater than (d)? If yes, the low-level exposure rule applies. If no, the low-level exposure rule does not apply; instead, the pro rata gross-up treatment applies.		Yes

Reporting in Schedule RC-R:

The low-level exposure rule applies to the bank’s investment in the mezzanine security, which means that a dollar-for-dollar capital charge applies to the investment. Regardless of whether the investment is categorized as an AFS or an HTM security on the Call Report balance sheet, it will not be risk-weighted as a balance sheet asset. Instead, it will be risk-weighted as an off-balance sheet item and the face amount of the bank’s investment must be reported in column A of Schedule RC-R, item 50, “Recourse and direct credit substitutes (other than financial standby letters of credit) subject to the low-level exposure rule and residual interests subject to a dollar-for-dollar capital requirement.” The face amount of an AFS and an HTM security is its amortized cost.

Case IIIA: Bank’s Investment in the Mezzanine Tranche is an AFS Security

Assume the fair value of the bank’s investment is \$1.20 and its amortized cost is \$2.75. Assume that the bank properly documents and supports that the \$1.55 unrealized loss on this AFS security is a temporary impairment, and it is reported, net of tax effect, on the Call Report balance sheet in Schedule RC, item 26.b, “Accumulated other comprehensive income.” The \$1.20 fair value of this investment is included on the Call Report balance sheet in Schedule RC, item 2.b, “Available-for-sale securities,” and on the regulatory capital schedule in column A of Schedule RC-R, item 36, “Available-for-sale securities.” Because the low-level exposure rule applies to the bank’s investment in the mezzanine security, the \$1.20 fair value of the investment is reported as a positive number in column B of Schedule RC-R, item 36, “Available-for-sale securities,” and no amount is reported for this security in columns C through F of item 36. This will ensure that the amount reported in item 36, column A, for the bank’s AFS investment (\$1.20) equals the sum of item 36, columns B through F (\$1.20).

Next, because AFS securities are risk-weighted using their amortized cost rather than their fair value, the bank’s maximum contractual exposure to loss on its investment in the mezzanine security is the investment’s amortized cost of \$2.75. The bank must report this \$2.75 amortized cost in column A of Schedule RC-R, item 50. It must then apply either the “direct reduction method” or the “gross-up method” described in the instructions for item 50 in order to determine the credit equivalent amount of its investment, which is a direct credit substitute. For example, if the bank applies the “gross-up method,” it must multiply the investment’s \$2.75 amortized cost by 12.5 and report the product (\$34.38) in Schedule RC-R, item 50, column B, “Credit equivalent amount.” The product must also be assigned to the 100 percent risk weight category (regardless of the risk weight that applies to the assets underlying the asset-backed security structure) and reported in Schedule RC-R, item 50, column F, “100%.”

	Column A	Column B	Column F
	Totals	Items Not Subject to Risk-Weighting	100%
36 Available-for-sale securities	\$1.20	\$1.20	

	Column A	Column B	Column F
	Face Value	Credit Equivalent Amount	100%
50 Recourse and direct credit substitutes subject to the low-level exposure rule	\$2.75	\$34.38	\$34.38

Case IIIB: Bank’s Investment in the Mezzanine Tranche is an HTM Security

Assume the amortized cost of the bank’s investment is \$2.75 and its fair value is \$1.20. Assume the bank properly documents and supports that the \$1.55 unrealized loss on this HTM security is a temporary impairment, which is not reflected on the balance sheet. The \$2.75 amortized cost of this investment is included on the Call Report balance sheet in Schedule RC, item 2.a, “Held-to-maturity securities,” and on the regulatory capital schedule in column A of Schedule RC-R, item 35, “Held-to-maturity securities.” Because the low-level exposure rule applies to the bank’s investment in the mezzanine security, the \$2.75 amortized cost of the investment is reported as a positive number in column B of Schedule RC-R, item 35, “Held-to-maturity securities,” and no amount is reported for this security in columns C through F of item 35. This will ensure that the amount reported in item 35, column A, for the bank’s HTM investment (\$2.75) equals the sum of item 35, columns B through F (\$2.75).

Next, because HTM securities are risk-weighted using their amortized cost, the bank’s maximum contractual exposure to loss on its investment in the mezzanine security is the investment’s amortized cost of \$2.75. The bank must report this \$2.75 amortized cost in column A of Schedule RC-R, item 50. It must then apply either the “direct reduction method” or the “gross-up method” described in the instructions for item 50 in order to determine the credit equivalent amount of its investment, which is a direct credit substitute. For example, if the bank applies the “gross-up method,” it must multiply the investment’s \$2.75 amortized cost by 12.5 and report the product (\$34.38) in Schedule RC-R, item 50, column B, “Credit equivalent amount.” The product must also be assigned to the 100 percent risk weight category (regardless of the risk weight that applies to the assets underlying the asset-backed security structure) and reported in Schedule RC-R, item 50, column F, “100%.”

	Column A	Column B	Column F
	Totals	Items Not Subject to Risk-Weighting	100%
35 Held-to-maturity securities	\$2.75	\$2.75	

	Column A	Column B	Column F
	Face Value	Credit Equivalent Amount	100%
50 Recourse and direct credit substitutes subject to the low-level exposure rule	\$2.75	\$34.38	\$34.38

Case IV: Bank’s Investment in the Mezzanine Security is a Trading Security and its Fair Value is \$1.20 (Bank is Not Subject to the Market Risk Capital Requirement)

The risk-weighted asset amount for the bank’s investment in the mezzanine security, in which it holds a 60 percent interest, is determined as follows:

(a) Percentage share of the total currently outstanding par value of the mezzanine tranche owned by the bank (\$3/\$5)		60%
(b) Currently outstanding par value of the more senior positions supported by the mezzanine tranche		\$80
(c) Bank’s percentage share of the mezzanine tranche multiplied by currently outstanding par value of the more senior positions supported by the mezzanine tranche [(a) * (b)]	=	\$48.00
(d) “Face amount” of the bank’s purchased subordinated security (fair value)	+	\$1.20
(e) Sum of the “face amount” of the bank’s purchased subordinated security and the pro rata share of the more senior positions supported by the mezzanine tranche [(c) + (d)]	=	\$49.20
(f) Multiply the sum by the appropriate risk weight of the underlying assets	x	100%
(g) Risk-weighted asset amount for the bank’s share of the mezzanine tranche [(e) * (f)]	=	\$49.20
(h) Capital charge for the risk-weighted asset amount [.08 * (g)]	=	\$3.94
(i) Check for applicability of the low-level exposure rule: Is the capital charge for the risk-weighted asset amount greater than the bank’s maximum contractual exposure on its investment (the “face amount” of the bank’s investment in the mezzanine tranche), i.e., is (h) greater than (d)? If yes, the low-level exposure rule applies. If no, the low-level exposure rule does not apply; instead, the pro rata gross-up treatment applies.		Yes

Reporting in Schedule RC-R:

The low-level exposure rule applies to the bank’s investment in the mezzanine security, which means that a dollar-for-dollar capital charge applies to the investment. Even though the investment is reported as a trading asset on the balance sheet, it will not be risk-weighted as a balance sheet asset. Instead, it will be risk-weighted as an off-balance sheet item and the face amount of the bank’s investment must be reported in column A of Schedule RC-R, item 50, “Recourse and direct credit substitutes (other than financial standby letters of credit) subject to the low-level exposure rule and residual interests subject to a dollar-for-dollar capital requirement.” The face amount of a trading security is its fair value.

The face amount of the bank’s investment is \$1.20 fair value. This \$1.20 fair value is included on the Call Report balance sheet in Schedule RC, item 5, “Trading assets,” and on the regulatory capital schedule in column A of Schedule RC-R, item 41, “Trading assets.” Because the low-level exposure rule applies to the bank’s investment in the mezzanine security, the \$1.20 fair value of the investment is reported as a positive number in column B of Schedule RC-R, item 41, “Trading assets,” and no amount is reported for this security in columns C through F of item 41. This will ensure that the amount reported in item 41, column A, for the bank’s trading asset (\$1.20) equals the sum of item 41, columns B through F (\$1.20).

Next, because trading assets are risk-weighted using their fair value, the bank’s maximum contractual exposure to loss on its investment in the mezzanine security is the investment’s fair value of \$1.20. The bank must report this \$1.20 fair value in column A of Schedule RC-R, item 50. It must then apply either the “direct reduction method” or the “gross-up method” described in the instructions for item 50 in order to determine the credit equivalent amount of its investment, which is a direct credit substitute. For example, if the bank applies the “gross-up method,” it must multiply the investment’s \$1.20 fair value by 12.5 and report the product (\$15.00) in Schedule RC-R, item 50, column B, “Credit equivalent amount.” The product must also be assigned to the 100 percent risk weight category (regardless of the risk weight that applies to the assets underlying the asset-backed security structure) and reported in Schedule RC-R, item 50, column F, “100%.”

	Column A	Column B	Column F
	Totals	Items Not Subject to Risk-Weighting	100%
41 Trading assets	\$1.20	\$1.20	

	Column A	Column B	Column F
	Face Value	Credit Equivalent Amount	100%
50 Recourse and direct credit substitutes subject to the low-level exposure rule	\$1.20	\$15.00	\$15.00