Office of Thrift Supervision
Department of the Treasury

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RESCINDED

This rescission applies to the transmitting document only and not the attached interagency guidance. Refer to (OCC 2002-21) for the status of the attached interagency guidance.

May 23, 2002

MEMORANDUM FOR: **CHIEF EXECUTIVE OFFICERS**

FROM: Scott M. Albinson

SUBJECT: Unsafe and Unsound Use of Covenants Tied to Supervisory Actions in Securitization Documents

The Office of Thrift Supervision, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (FDIC) are issuing the attached interagency advisory to alert management and boards of directors regarding the use of certain contractual provisions in securitization documents. The use of such provisions (or covenants) as described in the attached advisory will be considered an unsafe and unsound practice.

The advisory describes how these covenants can be detrimental to the bank or thrift, that they may interfere with the supervisory process, impede the abilities of a receiver or conservator, and may obligate bank or thrift managers and board members to disclose confidential information in violation of the agencies' regulations. The advisory states that management and boards of directors should ensure that covenants related to supervisory actions or thresholds are not included in securitization documents. Management is encouraged to amend, modify, or remove these covenants in existing transactions. Any impediments that a thrift institution may have to taking such action should be documented and discussed with OTS.

If you have questions about the use of covenants in securitization documents, please contact Michael D. Solomon, Senior Program Manager for Capital Policy at (202) 906-5654, or David W. Riley, Project Manager at (202) 906-6669.

Attachment

INTERAGENCY ADVISORY ON THE UNSAFE AND UNSOUND USE OF COVENANTS TIED TO SUPERVISORY ACTIONS IN SECURITIZATION DOCUMENTS

PURPOSE

This advisory, issued jointly by the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the agencies) alerts banking organization management and boards of directors to the safety and soundness implications of certain covenants included in securitization documents. Reviews during recent examinations of documentation governing securitization transactions have uncovered the use of covenants that cite supervisory thresholds or adverse supervisory actions as triggers for early amortization events or the transfer of servicing. The inclusion of such covenants in securitization documents will be considered by the agencies as an unsafe and unsound banking practice[1] that undermines the objective of supervisory actions. An early amortization triggered by a supervisory action can create or exacerbate liquidity and earnings problems that can lead to further deterioration in the financial condition of the banking organization. In addition, in the event such covenants relate to the appointment of a conservator or receiver, they may impede the ability of the conservator or receiver to take action in the best interest of the conservatorship or receivership.

BACKGROUND

Recent securitization examinations at banking organizations have revealed structures with early amortization or servicing transfer covenants tied to supervisory actions or thresholds. Examples of supervisory actions and thresholds the agencies identified in securitization documents as trigger events for early amortization or the transfer of servicing include:

– The banking organization’s composite CAMELS or BOPEC rating is downgraded to a specific target, e.g., 3 or 4.

– The banking organization is notified by its primary federal regulator that it is no longer deemed to be “well-capitalized” as defined by the agencies’ regulations implementing the

[1] While the banking agencies are concerned about the use of covenants linked to supervisory actions or thresholds in general, this guidance pertains specifically to covenants that use supervisory actions as triggers for early amortization or the transfer of servicing.

prompt corrective action provisions of the Federal Deposit Insurance Corporation Improvement Act.

– The banking organization is placed under any type of written enforcement action by a supervisory authority, including a prompt corrective action directive, capital directive, cease and desist order, formal agreement, or memorandum of understanding.

The above list is not all-inclusive. Any contractual provisions that could result in the early amortization of the transaction or the transfer of servicing due, directly or indirectly, to the occurrence of a supervisory action or event are subject to this advisory.[2]

Revolving securitizations such as securitizations of credit cards, commercial loans (CLOs), and home equity lines of credit often use early amortization as a way of protecting investors from deterioration in asset quality. Early amortization events and servicer default triggers are typically defined in the prospectus, pooling and servicing agreement, or insurance agreement if a third-party insurance company guarantees the transaction. Early amortization triggers accelerate the repayment of the principal of the securities issued by the trust ahead of their scheduled maturity. The purpose of early amortization is to protect investors from prolonged exposure to a pool of receivables whose performance has deteriorated.

Typically, early amortization events are tied to quantitative economic triggers such as a minimum level of excess spread,[3] a level of delinquencies on the underlying receivables, or the minimum amount of seller's interest in the pooled receivables. If an early amortization event occurs, investors may lose confidence in the stability of the banking organization's asset-backed securities, limiting the ability of the organization to raise new funds through securitization. At the same time, the organization is continuing to book on balance sheet new receivables that need to be funded. A banking organization heavily reliant upon securitization and lacking alternative sources of funding that is faced with these circumstances will experience liquidity challenges. Covenants that require the transfer of servicing to a third party can result in the loss of earnings, inefficiencies associated with unused servicer capacity, and loss of customer confidence.

DISCUSSION

The agencies are concerned about the negative safety and soundness implications of covenants that link supervisory actions or thresholds to the trigger of early amortization or the transfer of

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[2] Securitization documents commonly include triggers related to the insolvency of the bank or the appointment of the FDIC as conservator or receiver. Provisions that trigger an early amortization due to the appointment of the FDIC as receiver or conservator impede the FDIC's ability to enforce contracts that would be beneficial to the institution or the receivership. These clauses, while not necessarily subject to criticism as being unsafe or unsound for open institutions, may be void or voidable as being in violation of section 11(e)(12) of the Federal Deposit Insurance Act. This section provides that the conservator or receiver of an insured depository institution may enforce a contract entered into by the institution notwithstanding a provision that the contract is terminable upon the insolvency of the institution or the appointment of a conservator or receiver.

[3] "Excess spread is generally defined as finance charge collections minus certificate interest, servicing fees, and charge-offs allocated to the series." Standard & Poor's Structured Finance Credit Card Criteria, p. 20.

servicing. Triggers related to supervisory actions can result in a banking organization experiencing an early amortization event at a time when its ability to access other funding sources is limited, thereby resulting in liquidity problems. Such triggers also could potentially inhibit supervisors from taking actions intended to cure problems at a troubled organization because those actions activate a trigger that could cause a worsening of the condition or failure of the organization. Moreover, triggers premised upon the action of banking supervisors could result in an early amortization event when the supervisory action is linked to events that have limited or no relevance to the performance of the securitized assets. Such events may include an adverse change in the issuing organization's supervisory composite rating or regulatory capital status, or a supervisory concern related to compliance with consumer lending laws and the Community Reinvestment Act.

The banking agencies are also concerned that covenants related to supervisory actions may obligate banking organization management to disclose confidential examination information. Management and board members are reminded that information contained within examination reports is confidential. Disclosure of such information by a banking organization's directors, officers, employees, attorneys, auditors, or independent auditors, without explicit authorization by the institution's primary regulator, is a violation of the agencies' regulations.

CONCLUSION

Banking organization management and boards of directors should ensure that covenants related to supervisory actions or thresholds are <u>not</u> included in securitization documents. Effective immediately, the use of covenants that provide for the early termination of the transaction or compel the transfer of servicing due, directly or indirectly, to the occurrence of a supervisory action or event will, under appropriate circumstances, be criticized as an unsafe and unsound banking practice. The agencies may also take other supervisory or enforcement actions such as requiring additional capital, denying capital relief under low-level recourse exposure provisions for risk-based capital (regardless of GAAP treatment), or other supervisory response at the discretion of the primary supervisor.

In existing transactions, examiners will consider the potential impact of such covenants when evaluating the overall condition of the banking organization, as well as specific component ratings of capital, liquidity, and management. Early amortization triggers will specifically be considered in the context of the banking organization's overall liquidity position and contingency funding plan. For organizations with limited access to other funding sources or a significant reliance upon securitization, the existence of these triggers presents a greater degree of supervisory concern. Any banking organization that uses securitization as a funding source should have a viable contingency funding plan in the event it can no longer access the securitization market. **Banking organization management is encouraged to amend, modify, or remove these covenants in existing transactions. Any impediments an institution may have to taking such action should be documented and discussed with its primary supervisor.**

ADDITIONAL INFORMATION

For further guidance on asset securitization issues contact:

Office of the Comptroller of the Currency - Greg Coleman, Treasury and Market Risk at (202) 874-2777, or Kelly Ballard, Treasury and Market Risk at (202) 874-4917.

Federal Deposit Insurance Corporation - Keith Ligon, manager, Training and Examination Support - Securities, Capital Markets, and Trust Branch at (202) 898-3618, or Michael Phillips, Counsel at (202) 898-3581.

Board of Governors of the Federal Reserve System - Tom Boemio, senior supervisory financial analyst, Supervisory and Risk Policy at (202) 452-2982, or Anna Lee Hewko, senior financial analyst, Supervisory and Risk Policy at (202) 530-6260.

Office of Thrift Supervision - Michael D. Solomon, senior program manager for Capital Policy at (202) 906-5654, or David W. Riley, project manager for Capital Policy at (202) 906-6669.