



Federal Deposit Insurance Corporation
550 17th Street NW, Washington, DC 20429

Division of Supervision

CAPITAL TREATMENT OF RESIDUAL INTERESTS IN ASSET SECURITIZATIONS

FIL-65-2000
September 27, 2000

TO: CHIEF EXECUTIVE OFFICER

SUBJECT: *Proposal to Amend the Regulatory Capital Treatment of Residual Interests in Asset Securitizations or Other Transfers of Financial Assets*

The Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision have jointly proposed the attached rule to amend the agencies' regulatory capital standards on the treatment of residual interests in asset securitizations or other transfers of financial assets. Comments on the proposed rule are due by December 26, 2000.

The proposal addresses the concerns with residual interests raised in the agencies' December 1999 "Interagency Guidance on Asset Securitization Activities" (see FIL-109-99). In this guidance, the agencies expressed concern about institutions that were holding inadequate capital against residual interests, valuing the assets improperly, and holding excessive amounts of these assets in relation to capital. In the guidance, the agencies indicated they were considering limiting or eliminating the amount of certain residual interests recognized in regulatory capital.

Residual interests are balance sheet assets that represent interests (including beneficial interests) in the transferred financial assets retained by the seller (or transferor) after a securitization or other transfer of financial assets. This proposal only covers those residual interests that are structured to absorb more than a pro-rata share of credit loss related to the transferred assets through subordination provisions or other credit enhancement techniques (i.e., credit enhancement). Examples of residual interests include interest-only strips receivable (I/O strips), spread accounts, cash collateral accounts, retained subordinated interests, and other similar forms of on-balance sheet assets that function as a credit enhancement. For purposes of the proposed rule, residual interests do not include interests purchased from a third party.

The proposed rule addresses the supervisory concerns arising from the illiquid and volatile nature of the residual interests that generally are retained by the securitizer or other seller of financial assets when those residual interests are used as a credit enhancement to support the transferred financial assets. The proposal also attempts to minimize excessive concentrations in those assets that can occur when a banking organization retains large residual interests in connection with a securitization transaction. Recent experience has shown that high concentrations of such residual interests can threaten the safety and soundness of insured depository institutions.

The proposed treatment would amend the leverage and risk-based capital requirements by:

- Requiring that "dollar-for-dollar" capital be held against residual interests from securitization activities that are retained on the balance sheet, even if the amount exceeds the full capital charge typically held against the assets transferred; and
- Restricting undue concentrations in such assets by placing residual interests within the 25 percent Tier 1 capital sublimit already established for nonmortgage servicing assets and purchased credit card relationships. Any amounts above this limit will be deducted from Tier 1 capital.

In addition, as discussed in the attached proposal, any final rules that address recourse arrangements or the capital treatment of residual interests will be consistent for regulatory capital purposes. On March 8, 2000, the four federal banking agencies issued a proposal to revise the treatment of recourse arrangements, direct credit substitutes, and asset securitizations under their risk-based capital standards. While residual interests fall within the scope of both the March securitization proposal and the attached proposal, the risk-based capital treatment of securitization transactions is addressed more broadly in the March proposal. Working with the other agencies, the FDIC plans to move forward with the securitization proposal over the coming months and will be taking into account the relationship between the two regulatory capital proposals.

For more information, please contact Keith A. Ligon (202-898-3618) in the FDIC's Division of Supervision, or Marc Goldstrom (202-898-8807) in the FDIC's Legal Division.

James L. Sexton
Director

Attachment: Federal Register, September 27, 2000 (Volume 65, Number 188), pages 57993-58011

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