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

Division of Supervision

CAPITAL STANDARDS

FIL-99-2001
November 29, 2001

TO: CHIEF EXECUTIVE OFFICER

SUBJECT: *Final Rule to Amend the Regulatory Capital Treatment of Recourse Arrangements, Direct Credit Substitutes, Residual Interests in Asset Securitizations, and Asset-Backed and Mortgage-Backed Securities*

The Federal Deposit Insurance Corporation (FDIC), 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 adopted the attached final rule concerning regulatory capital standards.

The new rule amends the regulatory capital treatment of recourse arrangements, direct credit substitutes, residual interests in asset securitizations, and asset- and mortgage-backed securities, better aligning regulatory capital requirements with the risk associated with these positions.

The rule primarily affects banks involved in securitization-related activities, including banks that sell and securitize assets, service assets, guarantee the performance of a third party's assets, or invest in asset-backed and mortgage-backed securities.

Banks involved in the securitization or sale of assets often provide credit enhancements - generally referred to in the final rule as recourse, direct credit substitutes, and residual interests - in order to protect investors from incurring credit losses on loans and other financial assets that have been sold or securitized. Recourse arises when a bank retains credit risk on assets it sells if the credit risk exceeds a pro rata share of the bank's claim on the assets. In a direct credit substitute, a bank assumes credit risk on a third-party asset and the risk exceeds the pro rata share of the bank's interest in the asset. A residual interest is an on-balance sheet asset created in an asset sale that exposes a bank to credit risk in excess of its pro rata claim on the asset.

The final rule amends the current regulatory capital standards by:

- Providing a more consistent risk-based capital treatment of recourse obligations and direct credit substitutes and adding new capital standards for residual interests.
- Establishing a concentration limit for credit-enhancing interest-only strips, a form of residual interest, by requiring banks to deduct from Tier 1 capital and assets the face amount of credit-enhancing interest-only strips, whether retained or purchased, that exceed 25 percent of Tier 1 capital.
- Requiring banks to hold one dollar in total risk-based capital against every dollar of the face amount of a residual interest that is not eligible for the ratings-based approach, except for credit-enhancing interest-only strips that have already been deducted from Tier 1 capital under the concentration limit.

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- Applying a ratings-based approach that sets the capital requirements for asset- and mortgage-backed securities and other positions in securitization transactions (except for credit-enhancing interest-only strips) according to their relative risk using credit ratings from rating agencies to measure the level of risk.
- Permitting the limited use of a bank's qualifying internal risk rating system or qualifying rating agency programs and software to determine the risk-based capital requirement for certain unrated direct credit substitutes and recourse obligations, but not residual interests.
- Providing each regulatory agency with the reservation of authority to modify a stated risk-weight or credit-conversion factor on a case-by-case basis.

The final rule takes effect on January 1, 2002. Any transactions settled on or after January 1, 2002, are subject to this rule. Early adoption of the rule is permitted for transactions settled before the effective date that result in a reduced capital requirement. Conversely, banks may delay until December 31, 2002, the application of the final rule to transactions settled before January 1 that result in increased capital requirements.

The final rule does not include a managed assets capital charge for revolving credit securitizations that contain an early amortization feature (e.g., credit card securitizations). The regulatory agencies strongly believe that the risks associated with securitization, including those posed by an early amortization feature, are not fully captured in their current regulatory capital standards, and expect to address this risk either in a future rulemaking or through supervisory guidance.

For more information, please contact your FDIC regional office; Robert F. Storch (202-898-8906) or Jason C. Cave (202-898-3548), Division of Supervision; or Michael B. Phillips (202-898-3581) or Marc J. Goldstrom (202-898-8807), Legal Division.

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Acting Director

Attachment: Nov. 29, 2001, *Federal Register*, pages 59614-59667

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