Office of the Comptroller of the Currency

Board of Governors of the Federal Reserve System

Interpretive Letter #988
April 2004
12 CFR 3

July 28, 2003

Dear **[ ]**:

This is in response to your letter to Michael L. Brosnan and Stuart Desch dated March 5, 2003, requesting a risk-based capital interpretation for **[ ]** (the Bank) for three proposed transactions. In your letter, you describe two synthetic securitizations of residential mortgage loans (Transactions 1 and 2) and a Government-Sponsored Enterprise (GSE) transaction (Transaction 3) and request approval to apply a risk-based capital treatment based on both the November 15, 1999 Joint Agency Guidance on Synthetic Collateralized Loan Obligations (Joint Agency Guidance),[1] and the November 29, 2001 final rule entitled "Capital Treatment of Recourse, Direct Credit Substitutes and Residual Interests in Asset Securitizations" (Final Rule).[2] The Office of the Comptroller of the Currency (OCC) and the Federal Reserve Board (FRB) staffs have determined that, while Transactions 1 and 2 are not specifically described in the Joint Agency Guidance or the Final Rule, the principles established in that guidance and rule may be applied to those proposed synthetic transactions. For Transaction 3, the mezzanine credit protection provided by the Bank should be considered credit support under the Final Rule and receive the capital treatment described therein. The risk-based capital treatment that should be applied to each of the transactions is described below. The risk-based capital treatment for Transactions 1 and 2 described in this letter is conditional upon the Bank satisfying the risk management and disclosure conditions detailed in the annex to the Joint Agency Guidance, as amended by this letter.

Transaction 1

In this synthetic structure, the Bank will select and isolate a static reference pool of whole loan residential mortgages, which remain on the Bank's balance sheet. The credit risk of the reference pool will be stratified into notional segments or tranches that are expected to consist of

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[1] OCC Bulletin 99-43, FRB SR Letter 99-32.
[2] 66 Fed. Reg. 59614 (November 29, 2001).

equity, mezzanine and senior positions. The Bank will retain the risk of the equity and senior positions, and all of the positions above the equity position will be rated by two nationally recognized statistical rating organizations (NRSROs). The mezzanine tranches are expected to be rated in the range of B to A, and the retained senior tranches will be rated AA and AAA. The Bank will subsequently enter into credit default swaps (CDS) with either an OECD bank, a securities firm counterparty that qualifies for a 20% risk weight, or with a Bank-sponsored variable interest entity. If a variable interest entity is used, the entity will issue credit-linked notes (CLNs) to unaffiliated third parties equal to the notional amount of the CDS. The proceeds from the issuance of the CLNs will be invested in OECD government and GSE securities that will be held as collateral for the CDS. Regardless of whether a variable interest entity is used, the CDS will reference the payment and credit performance of the loans in the reference pool and will provide the Bank with credit protection in the event credit losses exceed the retained equity position. The maturities of the CDS will match the maturities of each referenced tranche, which will match the maturity of the longest loan in the reference pool.

The proposed Transaction 1 is similar, but not identical, to Structure 2 in the Joint Agency Guidance.[3] In both structures, the Bank retains the first loss position and the senior position and obtains credit protection on the rated mezzanine positions. However, in the Joint Agency Guidance, the mezzanine position includes a tranche rated AAA. As a result, the retained position is senior to a AAA rated position. In Transaction 1 proposed by the Bank, the highest rating on the mezzanine position is A and the retained senior positions are rated AA and AAA. Additionally, the credit protection obtained for the mezzanine position in Structure 2 in the Joint Agency Guidance was in the form of CLNs collateralized by OECD government securities. In the proposed Transaction 1, the credit protection on the mezzanine position may be in the form of either CDS or CLNs collateralized by both OECD government securities and GSE securities.

Risk-Based Capital Treatment for Transaction 1

The preamble to the Final Rule states, "With the issuance of this final rule, the agencies reaffirm the validity of the structural and risk management requirements of the [November] 1999 guidance on synthetic securitizations issued by the Board and the OCC, while modifying the risk-based capital treatment detailed therein with the treatment presented in this final rule."[4] This statement was further clarified by the "Interagency Questions and Answers on the Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations" (Interagency Q & A).[5] The Interagency Q & A modified the qualification requirements for Structure 2 in the Joint Agency Guidance to eliminate the restriction on the size of the first-loss position. Consequently, the Final Rule does not alter the risk-based capital treatment for this type of transaction: dollar-for-dollar capital on the retained first loss piece, recognition of the collateral to reduce the risk weight on the mezzanine position, and a 20% risk weight on the retained senior position if it is senior to AAA-rated CLNs.

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[3] In the Joint Agency Guidance issued in November 1999, the size of the retained first loss position in Structure 2 was limited to the expected loss on the portfolio. However, the OCC and FRB subsequently removed that limitation as described in Section IV.C. of "Interagency Questions and Answers on the Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations" (OCC Bulletin 2002-22, FRB SR Letter 2002-16, May 23, 2002).

[4] 66 Fed. Reg. 59622.

[5] OCC Bulletin 2002-22, FRB SR Letter 2002-16, May 23 2002.

The Final Rule explicitly references credit derivatives as examples of recourse and direct credit substitute exposures. A bank or bank holding company (a banking organization) providing credit protection through a credit derivative would therefore be considered to have a recourse or direct credit substitute exposure, the capital treatment for which is described in the Final Rule. However, the Final Rule does not explicitly address the situation where a banking organization has purchased credit protection through the use of a credit derivative. While the Bank in Transaction 1 has obtained credit protection through a credit derivative in a synthetic securitization, it has neither retained credit risk on sold assets (recourse) nor assumed credit risk associated with an asset that was not previously owned by it (direct credit substitute). Therefore, the risk-based capital treatment for either recourse or direct credit substitute positions established by the Final Rule is not directly applicable to the retained senior position in Transaction 1.

The OCC and FRB staffs believe that the principles established in the Final Rule, the Joint Agency Guidance, and the Interagency Q & A may be applied to the synthetic securitization described by the Bank as Transaction 1. The Bank may recognize the AA and AAA ratings received on the retained senior positions and assign a 20% risk weight to those untraded positions in accordance with the ratings-based approach of the Final Rule. The Bank must hold dollar-for-dollar capital for the retained equity position. If the credit protection obtained on the mezzanine position is in the form of CDS, the Bank could risk weight that position according to the risk weight appropriate for the counterparty. If the credit protection is in the form of CLNs collateralized by OECD government securities, the Bank could risk weight the position at 0% according to the Joint Agency Guidance. If the credit protection is in the form of CLNs collateralized by GSE securities, the Bank could risk weight the position at 20% according to the Agencies' risk-based capital rules for the recognition of collateral.

The OCC and FRB staffs consider this risk-based capital interpretation as a new case under the Joint Agency Guidance, and therefore, the capital treatment is subject to the Bank satisfying the risk management and disclosure requirements contained in the annex to that guidance. After reviewing the conditions in the annex in the context of industry advances in the risk measurement and management of synthetic securitizations since the publication of the Joint Agency Guidance, the OCC and FRB staffs have decided to modify the requirements of that annex. Those modifications are described later in this letter.

Transaction 2

Transaction 2 is identical to Transaction 1 except for the addition of a call option and loan removal provisions. The call option permits the Bank to call a tranche of the synthetic securitization that has third-party credit protection under two circumstances: (1) if a tranche with third-party credit protection receives a rating upgrade to AAA from all NRSROs rating the position; or (2) if all of the loans in the original reference portfolio are no longer on the Bank's balance sheet. The call option allows the Bank to "right size" the credit protection when the credit quality of the portfolio has improved significantly or the protection is no longer needed. If CLNs were issued, the Bank would pay a premium on the CLN redemption if it exercised the option within five years of closing the transaction.

The on-balance sheet loans that the Bank selects for the reference portfolio will be loans that are held for asset and liability management purposes. As part of its liquidity management process, the Bank may find it necessary or advantageous to sell or securitize the earmarked loans. The terms of Transaction 2 permit the Bank to sell or securitize such loans provided the loans are no more than 30 days past due.

As described in your letter and in follow-up conversations among OCC, FRB and the Bank's staff, you have represented that the call feature and loan removal provision are not intended to provide credit support to the synthetic securitization. The Bank generally may only exercise the options when the credit quality of the portfolio has improved or remains constant. If the credit quality of the pool has deteriorated, the CLN tranches would be less likely to receive a rating upgrade to AAA, making those tranches ineligible to be called.

Risk-Based Capital Treatment for Transaction 2

The Bank may apply the same risk-based capital treatment for Transaction 2 as described above in this letter for Transaction 1. If the Bank exercises its call options so that all of the mezzanine CDS and CLNs are called, the structure would no longer be considered a securitization since there would no longer be any risk transference. The Bank would now be exposed to the entire remaining amount of the mortgage portfolio, including that portion initially protected by the mezzanine tranches issued to third parties. The residential mortgages would be risk-weighted as loans held on the balance sheet according to the OCC risk-based capital rules contained in 12 CFR 3, Appendix A Section 3(a) and the FRB rules contained in 12 CFR 208, Appendix A, section III.C. and 12 CFR 225, Appendix A, section III.C.

Additionally, if the OCC or FRB determines that the Bank is exercising the call option or loan removal provision in order to provide credit enhancement or support to the counterparties providing the mezzanine credit protection, such actions will be considered implicit recourse and will alter the capital interpretations described in this letter.

As with Transaction 1, the Bank must satisfy the risk measurement and management conditions described in the annex of the Joint Agency Guidance, as modified later in this letter.

Transaction 3

In this structure, the Bank would select a pool of whole loan residential mortgages and transfer the loans to a GSE in exchange for investment-grade, GSE-guaranteed mortgage-backed securities that have an undivided interest in the cash flows of the transferred loans. The Bank expects to sell to third parties all of these securities and will pay the GSE an annual agency or guarantee fee for the GSE's guarantee of the timely payment of principal and interest on the securities. Contemporaneous with the transfer of loans, the Bank will provide a mezzanine-level credit enhancement to the GSE on the pool sold, which may take the form of an upfront Bank-funded spread account or a credit default swap. The Bank will receive market compensation for this enhancement, either in the form of fees received or a reduced rate for the guarantee fee paid by the Bank to the GSE.

The GSE will take the first-dollar loss risk on the sold mortgage pool. The Bank enhancement will be structured to provide second-dollar loss protection above the GSE first loss position, up to a specified amount of cumulative losses. This position will be either unrated or rated by two NRSROs at BB and/or BBB.

Risk-Based Capital Treatment for Transaction 3

The OCC and FRB staffs generally agree with the risk-based capital treatment described in your letter. Based on the Final Rule, the credit support provided by the bank should be treated as a recourse exposure, a residual interest, or a credit-enhancing interest only strip, depending on its exact structure. For example, if the enhancement is provided through an off-balance sheet credit default swap, then the position should be treated as a recourse exposure. If the protection is provided through an on-balance sheet spread account, then the position should be treated as a residual interest, or possibly a credit-enhancing interest-only strip. In addition, the applicable risk-based capital treatment might also depend on whether the enhancement is rated. Regardless of the precise form that the credit protection might take, the Final Rule should be used to assess the appropriate risk-based capital treatment.

Any GSE securities held should be accorded a 20% risk weight based on the GSE guarantee.

As you note in your letter, we would expect the portfolio to be continuously monitored, and if actual loss experience approaches or exceeds the GSE's equity position, the Bank should make appropriate valuation adjustments to the CDS or the spread account and, as applicable, risk-based capital adjustments consistent with any changes in NRSRO ratings.

Modifications to the Annex of the Joint Agency Guidance

The 1999 Joint Agency Guidance includes risk management, measurement, and disclosure requirements that a banking organization must satisfy in order for a synthetic securitization to qualify for the risk-based capital treatment described in the guidance. At the time the guidance was written, synthetic securitizations were a recent innovation, and both banking organizations and the regulatory agencies were just beginning to assess and understand the risks of such structures. As a prudential measure to ensure safety and soundness at banking organizations obtaining credit protection through such structures, the OCC and FRB developed preconditions for the preferential capital treatment described in the guidance that were intended to ensure a banking organization's ability to measure and manage the risk of both the protected on-balance sheet portfolio, as well as its unprotected positions. Since the OCC and FRB published the guidance, synthetic securitizations have become more commonplace and the technology to measure and manage the associated risks has improved. In addition, implementation of the Final Rule has provided a framework for a more risk-sensitive approach to assessing regulatory capital than was available when the guidance was published. The OCC and FRB staffs have therefore decided to modify the conditions of the annex of the Joint Agency Guidance to better reflect these developments. The OCC and FRB plan to include these modifications in a future interagency issuance on securitization.

Condition 1 of the annex requires a banking organization to "demonstrate that a transfer of virtually all of the risk has been achieved." The OCC and FRB have modified this condition to require banking organizations to "demonstrate that risk transference has been achieved." Similarly, Condition 1.1 has been amended from "Produce credible analyses indicating a transfer of virtually all of the credit risk to substantive third parties" to read, "Produce credible analyses indicating the degree of transfer of credit risk to substantive third parties." The OCC and FRB have also amended condition 1.7, which was intended to ensure that a banking organization transferred all of the credit risk of the protected portfolio and did not reassume it in another form. The revised condition now permits institutions to retain the senior risk position. However, it continues to preclude the reassumption of any credit risk transferred to third parties in another form for purposes of lowering the risk-based capital requirements.

Condition 1.5, which requires that the mezzanine position that is sold to third parties include a tranche that is rated AAA, has been eliminated. Condition 1.6, which limited the size of the retained first loss position to no greater than the expected loss on the portfolio, was previously eliminated with the publication of the Interagency Q & A.

Condition 3 of the annex requires a banking organization to disclose in its annual and SEC regulatory reports details of synthetic securitization transactions, including the amount of reduction in economic and regulatory capital as well as risk-weighted assets. The OCC and FRB staffs have modified these disclosure requirements to apply only when synthetic securitization transactions result in a material reduction in economic or regulatory capital.

A revised version of the annex incorporating the changes discussed above is attached.

Conclusion

The risk-based capital treatments described above apply only to transactions that meet the descriptions and satisfy the conditions outlined in this letter. The treatment of other transactions will depend on the structure and terms of those transactions. The OCC and FRB staffs will continue to review and issue risk-based capital interpretations on synthetic securitizations using credit derivatives on a case-by-case basis.

If you have further questions, please contact the resident OCC examiners, Margot Schwadron on 202-874-6022 or Amrit Sekhon on 202-874-5211 in the OCC Capital Policy Division, or Tom Boemio on 202-452-2982 in the FRB Supervisory and Risk Policy Section.

Sincerely,

/s/ /s/

Tommy Snow
Director, Capital Policy
Comptroller of the Currency

Barbara Bouchard
Assistant Director
Federal Reserve Board

REVISED ANNEX

Minimum Conditions that Sponsoring Institutions
Must Meet to Obtain the Synthetic Securitization Capital Treatment

The Agencies may impose additional requirements or conditions as they deem necessary to ascertain that the sponsoring banking organization has sufficiently isolated itself from the credit risk exposure of the hedged reference portfolio.

Condition 1: Demonstration of Transfer of Virtually All of the Risk to Third Parties

Not all transactions structured as synthetic securitizations transfer the degree of credit risk needed to receive a reduced ~~20 percent~~ risk weight on the retained senior position. To demonstrate that ~~a transfer of virtually all of the~~ *risk transference* has been achieved, institutions must:

1. Produce credible analyses indicating ~~a transfer of virtually all~~ *the degree of transfer* of the credit risk to substantive third parties;

2. Ensure the absence of any early amortization or other credit performance contingent clauses;[6]

3. Subject the transaction to market discipline through the issuance of a substantive amount of notes or securities to the capital markets;

4. Have notes or securities rated by a nationally recognized credit rating agency;

5. ~~Structure a senior class of notes that receives the highest possible investment grade rating, e.g., AAA, from a nationally recognized credit rating agency;~~

6. ~~Ensure that any first loss position retained by the sponsoring institution in the form of fees, reserves, or other credit enhancement -- which effectively must be deducted from capital -- is no greater than a reasonable estimate of expected losses on the reference portfolio; and~~

[6] Early amortization clauses may generally be defined as features that are designed to force a wind-down of a securitization program and rapid repayment of principal to asset-backed securities investors if the credit quality of the underlying asset pool deteriorates significantly.

7. Ensure that they do not reassume any *transferred* credit risk ~~beyond the first loss position~~ through another credit derivative or any other means.

Condition 2: Demonstration of Ability to Evaluate Remaining Banking Book Risk Exposures and Provide Adequate Capital Support

To ensure that the sponsoring institution has adequate capital for the credit risk of its unhedged exposures, institutions are expected to have adequate systems that fully take into account the effect of such transactions on the institutions' risk profiles and capital adequacy. In particular, those systems should be capable of fully differentiating the nature and quality of the risk exposures an institution transfers from the nature and quality of the risk exposures it retains. Specifically, to gain capital relief institutions are expected to:

1. Have a credible internal process for grading credit risk exposures, including: (1) adequate differentiation of risk among risk grades, (2) adequate controls to ensure the objectivity and consistency of the rating process, and (3) analysis or evidence supporting the accuracy or appropriateness of the risk grading system.

2. Have a credible internal economic capital assessment process that defines the institution to be adequately capitalized at an appropriate insolvency probability and that readjusts, as necessary, its internal economic capital requirements to take into account the effect of the synthetic securitization transaction. In addition, the process should employ a time horizon sufficiently long to allow necessary adjustments in the event of significant losses. The results of an exercise demonstrating that the organization is adequately capitalized after the securitization transaction must be presented for examiner review.

3. Evaluate the effect of the transaction on the nature and distribution of the non-transferred banking book exposures. This analysis should include a comparison of the banking book's risk profile and economic capital requirements before and after the transaction, including the mix of exposures by risk grade and by business or economic sector. The analysis also should include identification of any concentrations of credit risk and maturity mismatches. Additionally, the bank must adequately manage and control the forward credit exposure that arises from any maturity mismatch. The Agencies retain the flexibility to require additional regulatory capital if the maturity mismatches are substantive enough so that they raise a supervisory concern. Moreover, as stated above, the sponsoring banking organization must demonstrate that it meets its internal economic capital requirement subsequent to the completion of the synthetic securitization.

4. Perform rigorous and robust forward-looking stress testing on non-transferred exposures (remaining banking book loans and commitments), transferred

exposures, and exposures retained to facilitate transfers (credit enhancements). The stress tests must demonstrate that the level of credit enhancement is sufficient to protect the sponsoring bank from losses under scenarios appropriate to the specific transaction.

Condition 3: Provide adequate public disclosures of such transactions regarding their risk profile and capital adequacy.

When synthetic securitization transactions result in a material reduction in economic or regulatory capital, sponsoring institutions must provide adequate disclosure to the marketplace in their 10-K and annual reports on the accounting, economic, and regulatory consequences of such transactions. In particular, institutions are expected to disclose:

1. The notional amount of loans and commitments involved in the transactions;

2. The amount of economic capital shed through the transactions;

3. The amount of reduction in risk-weighted assets and regulatory capital resulting from the transactions both in dollar terms and in terms of the effect in basis points on the risk-based capital ratios; and

4. The effect of the transactions on the distribution and concentration of risk in the retained portfolio by risk grade and sector.