## Appendix D: Changes in Laws and Regulations Impacting National Banks Engaging in the Issuance and Sale of Asset-Backed and Structured Investments

The roles of banks in mortgage asset securitization in recent years is the product of an evolution in recognition by agencies, courts and Congress of the authority and desirability of permitting asset securitization as a means of selling or borrowing against loan assets.[1] National banks engaged in the first securitizations of residential mortgage loans as far back as the 1970s under the same laws that permit national banks to securitize their assets today. Since that time, there has been significant growth in the number and complexity of asset-backed securitizations.[2] Congress encouraged some of this growth in the 1980s and 1990s by expanding the authority of national banks and other financial institutions to purchase certain mortgage-related and small business-related securitized assets.

But many other factors, beyond legal authority, have driven the tremendous growth of the securitization market by creating incentives for market participants to use securitizations. These factors, as described below, include reallocating risks such as credit and interest rate risk among originators and investors, providing new sources of funding and liquidity and achieving favorable accounting and capital treatment. Market events, along with recent changes in regulatory capital requirements and accounting rules have altered some of these incentives. Nevertheless, the securitization market is expected to continue to be an important source of credit for the economy in the future.[3]

### I. Evolution and Growth of Asset-Backed Securitization

The origin of securitization activities in the United States is generally attributed to the evolution and developments in the secondary markets for residential mortgages.[4] In 1938, the Federal National Mortgage Association (Fannie Mae's ancestor) was created to encourage the maintenance of an active secondary market for mortgages.[5] The first pass-through mortgage securities were introduced by the Government National Mortgage Association ("GNMA") in 1970.[6] Until that time, lenders that wanted to reduce their exposure to rising interest rates had to buy and sell whole loans. But the market for whole loans was relatively illiquid and buying and selling individual whole loans was costly and inefficient. By combining mortgage loans into pools, GNMA was able to pass the mortgage payments through to the certificate holders or investors. Although this innovation provided lenders and investors with a more liquid market, it left investors exposed to prepayment risk (the unexpected return of principal).

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[1] National banks may play a number of different roles in securitization transactions, including lender, investor, originator, servicer and sponsor.

[2] Asset-backed securitization is a financing technique in which loans or other financial assets are pooled and converted into instruments that may be offered and sold in the capital markets. Asset-backed commercial paper conduits fit within this broad definition and specifically involve the financing of assets through the continuous roll-over of short-term liabilities, typically commercial paper. *See generally* Comptroller's Handbook, *Asset Securitization* (Nov. 1997) ("Comptroller's Handbook"); Securities and Exchange Commission (SEC), *Asset-Backed Securities*, 70 Fed. Reg. 1506, 1511-12 (Jan. 7, 2005).

[3] The securitization market accounted for about 30 percent of credit provision in the United States by the end of 2008.

[4] *See* Christine A. Pavel, *Securitization: The Analysis and Development of the Loan-Based/Asset-Backed Securities Markets* (Probus Publishing) (1989).

[5] Frank J. Fabozzi, editor, *Advances & Innovations in the Bond and Mortgage Markets*, p. 175 (Probus Publishing) (1989) ("Fabozzi").

[6] *Id.* at 262.

In response to investor demand, in 1983, Freddie Mac issued the first collateralized mortgage obligation (CMO), which allowed payments to be directed to certain classes of debt securities in a specified order, allowing for different interest rates, payment schedules, and maturity dates.[7]

The securitization market continued its exponential growth through the 1990s and into the 2000s.[8] In particular, the last decade has witnessed tremendous growth in the use of special purpose entities (SPEs) to securitize assets.[9] To appreciate the reason for this growth, it is important to understand the motivations of originators and investors in using these structures. For example, one of the primary purposes of SPEs is reallocating credit risk by legally isolating the assets held by the SPE from the originating institution. For the originator, this has the advantage of potentially limiting its legal obligation to perform on the debts issued by the SPE.[10] For the investor, investing in a bankruptcy remote entity allows the investor to focus on the risks associated with certain assets rather than having to assess the entire business of the originator and its creditworthiness.

Another key motivation for originators to use SPEs is to access additional sources of funding and liquidity and to reduce funding costs. One of the primary functions that SPEs serve is to allow the originating institution to transform less liquid, non-rated exposures into more liquid, rated securities. This can provide the issuing institution enhanced liquidity through an expanded funding base and lower funding costs. This enhanced liquidity is also a benefit to investors because these securities can be more easily traded in the secondary market or used as collateral in securities funding transactions.[11]

Originators have also used SPEs to achieve off-balance sheet accounting treatment. Recent changes in accounting standards have significantly reduced the ability of sponsors to use SPEs to achieve off-balance sheet treatment, however. These new standards, FAS 166 and FAS

[7] Creating different classes of debt securities, known as "tranched" securitization, was later applied to other asset classes, such as equipment leases and auto loans, starting in 1985. Fabozzi, *supra* at 527.

[8] In the early 2000s, there was significant growth in the issuance of private-label securitizations. This period also witnessed a rapid growth in the unregulated financial industry – resulting from the use of SPEs to raise money in the capital markets for lending and investing, rather than through the use of bank balance sheets. This discussion focuses on asset securitizations involving regulated financial institutions.

[9] An SPE is a legal entity created at the direction of a sponsoring firm. An SPE can take the form of a corporation, trust, partnership, or limited liability company. SPEs are generally structured to be bankruptcy remote from the sponsoring firm. As discussed below, SPEs are used for a variety of business purposes. *See also* Basel Committee on Bank Supervision, *The Joint Forum Report on Special Purpose Entities* (Sept. 2009) (Joint Forum Report).

[10] The originator is the entity that generates receivables by means that include selling loans, selling goods and services on credit, and providing financing for the acquisition of goods and services, and then transfers those receivables (as Transferor), directly or indirectly, to an asset backed security issuing special purpose vehicle. Originators create and often service the assets that are sold or used as collateral for asset-backed securities. Originators include commercial banks, thrift institutions, captive finance companies of the major automakers, insurance companies, securities firms, and others.

[11] *See* Joint Forum Report at 18.

167, determine the extent to which a securitization transaction is on or off the financial statements of originators, servicers, and investors.[12]

Regulatory capital considerations also have played a significant role in the use of SPEs. The U.S. federal banking agencies have used generally accepted accounting principles (GAAP) as the initial basis for determining whether an exposure is treated as on- or off-balance sheet for risk-based and leverage capital purposes.[13] Since many securitization transactions were accorded sales treatment under prior accounting standards, significant capital benefits were derived from securitization of bank assets. Recent capital regulatory changes fundamentally changed the capital consequences of securitizations. That is, because capital rules will generally continue to follow GAAP as the basis for determining whether an asset is on- or off-balance sheet, the fact that fewer SPEs will be treated as off-balance sheet for accounting purposes means that the same will be true for regulatory capital purposes.

Other recent changes to regulatory capital requirements also have significantly altered the incentives associated with securitization and other similar structures. For example, the development of the Basel II Framework has materially lessened the capital benefits associated with securitization. Under Basel I, banks could realize regulatory capital benefits from securitizations that transferred assets through SPEs. Due to its risk invariant capital requirements, Basel I created an incentive to remove assets from the balance sheet of a bank that had high regulatory capital requirements relative to the market's assessment of the assets' economic risk.[14]

Recently the Basel Committee on Banking Supervision announced additional enhancements to the Basel II Framework that materially affect securitization activities and the capital requirements for the largest U.S. banking companies. These enhancements will result in significant increases in the capital requirements for re-securitizations, such as collateralized debt obligations or CDOs.[15] Bank regulators hope to implement these changes by rules that would take effect at the beginning of 2011.

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[12] FAS 166 addresses whether securitizations and other transfers of financial assets are treated as sales or financings. *See* Statement of Financial Accounting Standards No. 166, Accounting for Transfers of Financial Assets (FAS 166). FAS 167 addresses whether certain legal entities often used in securitization and other structured finance transactions should be included in the consolidated financial statements of any particular interested party. *See* Statement of Financial Accounting Standards No. 167 (FAS 167).

[13] While GAAP does not dictate regulatory capital requirements, bank regulators believe GAAP is the most effective starting point for the development of regulatory capital requirements because GAAP is a consistent standard that can be used to compare bank performance, and financial reports under GAAP are subject to external audit. In addition, Federal statute requires the use of GAAP for financial reporting purposes. *See* 12 U.S.C. § 1831n.

[14] Differences between Basel I and Basel II's treatment of retained securitization exposures also provided incentives to securitize. The increased risk sensitivity of Basel II in measuring capital requirements for securitization-related exposures has reduced both of these incentives.

[15] These enhancements will result in increased capital requirements for securitization positions held in the trading book and the banking book as well as liquidity facilities for asset-backed commercial paper programs and securitizations where the bank failed to do its own due diligence on external credit quality, relying instead exclusively on credit ratings. *See* "Basel II Capital Framework Enhancements Announced by the Basel Committee" (July 13, 2009).

In sum, a number of factors have influenced the growth of securitizations and the use of SPEs in particular. Although the recent disruption in the securitization market has stalled this growth, some of the factors that influenced originators and investors to use securitizations in the past are still relevant today. For example, asset securitization will continue to provide an additional source of funding and liquidity even if SPEs are consolidated on the bank's balance sheet for regulatory capital purposes.[16]

## II. Legal Authority for National Banks to Issue and Securitize Assets

### *A. 12 U.S.C. § 24(Seventh)*

National banks and other U.S.-regulated financial institutions have long been permitted to use asset securitization as a means of selling or borrowing against loan assets. In language unaltered since the enactment of the National Bank Act in 1864, national banks are granted express authority to "carry on the business of banking; by discounting and negotiating promissory notes . . . and other evidences of debt.[17] The Courts have held that the right to discount and negotiate includes the right to buy and sell evidences of debt, including securitized assets.[18] In a leading case, the Second Circuit Court of Appeals held that Security Pacific National Bank could issue and sell interests in a pool of mortgages as a mechanism for selling loans.[19] The court recognized that the "pass-through certificate mechanism permits the bank to offer purchasers an interest in a pool of mortgage loans, rather than just single mortgage loans. . . With the increased marketability that pass-through certificates make possible comes increased liquidity, an important benefit as banks face the task of funding long term mortgage loans with short term deposits."[20]

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[16] *See* Joint Forum Report at 19.

[17] 12 U.S.C. § 24(Seventh). While 12 U.S.C. § 24(Seventh) on its own provides sufficient authority for these activities, 12 U.S.C. § 371(a) also permits the sale of mortgage-related assets. Section 371(a) authorizes a national bank to make and sell loans or extensions of credit secured by liens on interests in real estate, subject to any conditions or limitations set forth by the OCC.

[18] *See First Nat'l Bank of Hartford v. City of Hartford*, 273 U.S. 548, 559-60 (1927) (the Supreme Court determined that the sale of mortgages and other evidences of debt acquired through a national bank's exercise of its express power to lend money on the security of real estate, and to discount and negotiate other evidences of debt, was authorized as part of the business of banking under 12 U.S.C. § 24 (Seventh)). The courts have long held that the term "discount" includes the purchases of notes and other evidences of debt. *See, e.g., Danforth v. Nat'l State Bank*, 48 F. 271, 273-74 (3rd. Cir. 1891).

[19] *See Securities Industry Ass'n v. Clarke,* 885 F.2d 1034, 1050 (2d Cir. 1989), *cert. denied*, 439 U.S. 1070 (1990) ("*Security Pacific*"). The Second Circuit's decision upheld the OCC's interpretation under 12 U.S.C. § 24(Seventh) in Interpretive Letter No. 388, (June 16, 1987). The court also indicated that it had no difficulty concluding that the section 371(a) supported the OCC's conclusion that the bank had the express power to sell its mortgage loans. 885 F.2d. at 1048. In Interpretive Letter No. 388, the OCC explained the mortgage-backed pass-through certificates evidencing ownership interests in the banks' mortgage assets represented nothing more than the negotiation of evidences of debt and sale of real estate loans, under the express authority of 12 U.S.C. § 24(Seventh) and § 371(a). More generally, the OCC opined the transaction involved a sale of bank assets, which is fully permitted under the national banking laws.

[20] *Security Pacific,* 885 F.2d at 1049.

The Second Circuit held that the bank's activities were authorized as part of the business of banking and thus, were not prohibited by Section 16 of the Glass-Steagall Act.[21] The court recognized that the fact that the negotiation and sale may be accomplished through the creation and sale by a bank of asset-backed securities does not alter in any respect the substance of the transaction, nor its permissibility under the national banking laws.[22] Indeed, Courts have recognized that section 24(Seventh)'s grant of authority extends beyond the label given a certain activity and permits activities that are fundamentally banking in nature.[23]

### *B. Congress Has Repeatedly Reaffirmed the Authority of National Banks to Securitize Assets*

Congress has recognized and enhanced the authority of national banks to engage in securitization activities under 12 U.S.C. § 24(Seventh). In an effort to encourage private investment in the housing and small business markets, Congress removed the investment limits for certain types of mortgage and small business-related securities with the passage of the Secondary Mortgage Market Enhancement Act of 1984 ("SMMEA") and the Riegle Community Development and Regulatory Improvement Act of 1994 ("CDRI"). Prior to enactment of SMMEA and CDRI, national banks generally could not invest more than 10 percent of unimpaired capital and stock and surplus in the investment securities of any one issuer, with certain exceptions.[24] More recently, Congress recognized and preserved the ability of banks to engage in asset-backed transactions through the provisions enacted in the Gramm-Leach Bliley Act ("GLBA").

#### *1. SMMEA*

SMMEA amended 12 U.S.C. § 24(Seventh) to permit national banks to purchase without limitation certain residential and commercial mortgage-related securities offered and sold pursuant to section 4(5) of the Securities Act of 1933, 15 U.S.C. § 77d(5), or residential mortgage related securities as defined in section 3(a)(41) of the Exchange Act, 15 U.S.C. § 78c(a)(41).[25] The stated intent of Congress was to increase the flow of funds to the housing

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[21] Section 16 of the Glass-Steagall Act generally prohibits banks from underwriting or dealing in securities. The Second Circuit concluded that an activity that "falls within the business of banking is not subject to the restrictions [that] … section 16 places on a bank's 'business of dealing in securities and stocks.'" *Id.* at 1048. *See also, Securities Industry Ass'n v. Board of Governors of the Federal Reserve System,* 468 U.S. 137, 158 n.11 (1984). OCC decisions also recognized that the Glass-Steagall Act did not restrict the means by which national banks could sell or transfer interests in their assets. *See e.g.,* OCC Interpretive Letter No. 388, *supra* (pass-through certificates representing undivided interests in pooled bank assets are legally transparent for purposes of the Glass-Steagall analysis).

[22] *See* OCC Interpretive Letter No. 388 (June 16, 1987).

[23] *See American Ins. Ass'n v. Clarke,* 656 F. Supp. 404, 408-10 (D.D.C. 1987), *aff'd,* 856 F.2d 278 (D.C. 1988); *M&M Leasing Corp. v. Seattle First Nat'l Bank,* 563 F.2d 1377, 1382-83 (9th Cir. 1977); *see also* OCC Interpretive Letter No. 494 (Dec. 20, 1989); No-Objection Letter No. 87-9 (Dec. 16, 1987).

[24] Section 24 (Seventh) imposed no investment limitations on housing revenue bonds issued by municipalities and states and obligations of the Federal housing agencies, Ginnie Mae, Fannie Mae and Freddie Mac.

[25] SMMEA required that a "mortgage related security" be rated in one of the two highest rating categories. *See* 15 U.S.C. 78c(a)(41).

market by facilitating the participation of the private sector in the secondary mortgage market.[26] To accomplish this, SMMEA amended the Securities Exchange Act of 1934 to facilitate the development of a forward trading market in "mortgage related securities" and designate such securities as "legal investments" for state and federally regulated financial institutions.

*2. CDRI*

CDRI amended 12 U.S.C. § 24(Seventh) by removing limitations on purchases by national banks of certain small business-related and commercial mortgage-related securities.[27] The stated intent of Congress was to increase small business access to capital by removing impediments in existing law to the securitizations of small business loans.[28] CDRI built on the framework for securitizations established by SMMEA to create a similar framework for these securities with the goal of stimulating the flow of funds to small businesses.

CDRI also removed certain impediments to trading and investing in commercial mortgage related securities, including easing margin requirements under the federal securities laws and authorizing depository institutions to purchase these securities under conditions established by their regulators. At the same time, the CDRI preserved the existing authority of federal bank regulators to regulate bank purchases of commercial mortgage related securities.

*3. GLBA Exemption for Bank Securitization Activities*

GLBA amended the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(5), to eliminate the complete exemption of banks from the definition of "dealer" for purposes of the securities laws.[29] In so doing, however, Congress specifically provided certain exemptions for banks from the definition of dealer including a specific provision on asset-backed transactions. Section 78c(a)(5) provides:

> <u>Exception for certain bank activities</u>. A bank shall not be considered to be a dealer because the bank engages in any of the following activities under the conditions described: . . .

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[26] Senate Report (Banking, Housing and Urban Affairs Committee) No. 98-293 to accompany S. 2040 (Secondary Mortgage Market Enhancement Act of 1984), Vol. 130 Cong. Record 2809, 2814 (Sept. 26, 1984).

[27] CDRI defined a new type of "small business-related security" in section 3(a)(53)(A) of the Exchange Act, 15 U.S.C. § 78c(a)(53(A), and added a class of commercial mortgage related securities to section 3(a)(41) of the Exchange Act., 15 U.S.C. § 78c(a)(41). CDRI also provided that eligible residential and commercial mortgage-related securities must receive a rating from an NRSRO in one of the top two rating categories. Small business-related securities were required to receive a rating in one of the top four rating categories.

[28] *See* Conference Report on the CDRI, Vol. 140 Cong. Record, pp. H6685, H6690 (Aug. 2, 1994). *See also* Remarks of Sen. Domenici, Vol. 140 Cong. Record, p. S11039, S11043-43 (Aug. 2, 1994) (discussing national banks' authority to purchase commercial mortgage related securities under conditions established by the OCC).

[29] In adopting rules under this provision, the SEC noted that the question of whether a bank acts as a "dealer" under the securities laws is entirely separate from the banking law considerations. It is possible for a bank to be a "dealer" under the securities laws and not under the banking laws. *See* 68 Fed. Reg. 8686, 8689 (Feb. 24, 2003). Likewise, in the securitization context, it is important to recognize important distinctions in the applicable terminology to the parties involved in each transaction.

Asset-backed transactions. The bank engages in the issuance or sale to qualified investors, through a grantor trust or other separate entity, of securities backed by or representing an interest in notes, drafts, acceptances, loans, leases, receivables, other obligations (other than securities of which the bank is not the issuer), or pools of any such obligations predominantly originated by--

- the bank;
- an affiliate of any such bank other than a broker or dealer; or
- a syndicate of banks of which the bank is a member, if the obligations or pool of obligations consists of mortgage obligations or consumer related receivables.

The exception recognized and preserved the ability of banks to engage directly in these types of securitization activities, rather than conduct them in separate SEC-registered broker-dealer subsidiaries or affiliates.

### *C. The Impact of GLBA's Repeal of Certain Glass-Steagall Act Restrictions*

In 1999, as part of the GLBA, Congress repealed restrictions in the Glass-Steagall Act on affiliations between member banks and firms principally engaged in securities underwriting, distribution, and dealing activities that were not permissible for national banks. While GLBA repealed these restrictions, the repeal was not a marked change in the types of mortgage asset securitizations activities that could be conducted by banking organizations, since a wide range of mortgage asset securitization activities already were recognized as permissible for banks and had been specifically authorized by Congress and therefore were not within the scope of Glass-Steagall prohibitions.

Yet, the GLBA changes to the Glass-Steagall Act did have several notable results. The changes permitted affiliations between banks and firms engaged in more extensive investment banking business than had been permitted for affiliates of commercial banks. On the one hand, this introduced more of the investment banking culture into certain banking holding companies and a level of risk tolerance not typical for traditional bank risk managers. The manifestations of this culture shift presented new challenges for banking supervisors. On the other hand, the changes GLBA made to the framework for regulated bank holding companies ultimately were essential to enable large bank holding companies to rescue major securities firms that had been operating under less rigorous prudential standards than bank holding companies, and which were threatened by the financial turmoil. These acquisitions and the ability of major securities firms to fit into the bank holding company framework provided crucial support and market reassurance that was part of the process of restoring confidence in the stability of the financial system as a whole.

### *D. OCC Interpretive Letters and Regulations*

#### *1. OCC Interpretive Letters*

On the basis of banks' 12 U.S.C. § 24(Seventh) and 12 U.S.C. § 371(a) authorities, the OCC through the years has approved various structures and issuances of mortgage-backed securities ("MBS"), ABS, and other similar instruments.[30] For example, in 1988, in Interpretive Letter No. 418, the OCC approved a bank's operating subsidiary securitizing and issuing mortgage-related instruments based on assets held by its affiliates. As the OCC explained:

> [T]he activity of selling mortgages into the secondary market, or alternatively raising lendable funds by borrowing in the market secured by mortgages, may be accomplished by the use of the securitized formats which the market has developed in the last decades as well as by direct methods. The securitized formats are tools used to effect the selling, purchasing, borrowing, and lending functions of the secondary market. They were developed so that these market functions could be accomplished more efficiently, but they are mere tools, another means of performing the same functions.[31]

*2. 12 C.F.R. Part 1*

In 1996, the OCC codified at 12 C.F.R. § 1.3(g) its long-standing position, as affirmed by case law, that a national bank may securitize and sell assets that it originates or has acquired from others.[32] Section 1.3(g) today remains the same as in 1996 and provides:

> A national bank may securitize and sell assets that it holds, as a part of its banking business. The amount of securitized loans and obligations that a bank may sell is not limited to a specified percentage of the bank's capital and surplus.

In addition, the OCC's 1996 amendments to Part 1 added two new types of securities to effect the changes made by SMMEA and CDRI, as discussed above, and developments in

[30] *See, e.g.*, Letter from Robert L. Clarke, Comptroller of the Currency, to the Honorable Alfonse M. D'Amato, United States Senate (Jun. 18, 1986); Letter from Robert Bloom, Acting Comptroller of the Currency, to Bank of America (Mar. 29, 1977). In addition, earlier letters addressed the application of 12 U.S.C. § 82, now repealed, which limited the borrowings of a national bank, and the language of 12 U.S.C. § 378 (section 21of the Glass-Steagall Act), which was viewed originally as providing certain authorizing language (subsequently amended by the Secondary Mortgage Market Enhancement Act of 1983). *See, e.g.,* OCC Interpretive Letter No. 257 (Apr. 12, 1983).

[31] OCC Interpretive Letter No. 418 (Feb. 17, 1988). It has long been recognized that national banks have the power to borrow funds. Borrowing is an incidental bank power—a traditional power, "necessary to carry on the business of banking." *See Securities Industry Association v. Board of Governors of the Federal Reserve System*, 468 U.S. 137, 158 n.11 (1984). Moreover, the power to sell or transfer interests in one's assets is simply an incident of ownership. Ownership is defined in Black's Law Dictionary 997 (rev. 5th ed. 1979) as the "collection of rights to use and enjoy property, including [the] right to transmit it to others." As with any other corporation, in order to operate effectively, a bank must be able to sell its assets, or interests therein, as economic conditions or safety and soundness considerations warrant. The OCC has recognized that a bank's ability to sell interests in its long term mortgage-related portfolio serves specific banking purposes. The ability to sell mortgages which would otherwise be held for twenty or thirty years provides needed liquidity to the mortgage portfolio, resulting in the generation of additional funds for new lending and other purposes. The ability to sell mortgage assets on a regular basis also facilitates management of the maturity mismatch problems inherent in funding long term mortgages with shorter term deposits.

[32] Comptroller of the Currency, *Investment Securities*, 61 Fed. Reg. 63972, 63977 (Dec. 2, 1996) (adopting final rule and providing long list of OCC precedents). *See, e.g.*, OCC Interpretive Letter No. 585 (Jun. 8, 1992) (securitized motor vehicle retail installment sales contracts); OCC Interpretive Letter No. 540 (Dec. 12, 1990) (securitized credit card receivables); Interpretive OCC Letter No. 514 (May 5, 1990) (securitized mortgages).

national banks' treatment of their assets.[33] Thus, besides recognizing the ability of a national bank to securitize and sell its assets, Part 1 also recognizes a national bank's ability to purchase securitized assets as investment securities.

Specifically, the OCC amended 12 C.F.R. Part 1 to add "Type IV" securities, which are defined as certain types of asset-backed securities identified in SMMEA and CDRI, and which are exempt from the 10 percent investment limitation of 12 U.S.C. § 24(Seventh). Distinct from the Type IV securities, the 1996 rule also added "Type V" securities to address "investment grade" securities representing interests in assets a bank may invest in directly.[34] The rule defines a Type V security as a security rated investment grade, marketable, not a Type IV, and fully secured by interests in a pool of loans to numerous obligors and in which a national bank could invest in directly.[35] The OCC reiterated that "this definition reflect[s] the OCC's long-standing interpretations that, in addition to investments described in 12 U.S.C. § 24(Seventh), a national bank may hold securitized forms of assets in which it may invest directly."[36] The rule limits a bank's purchase of Type V securities from any one issuer (or certain related issuers) to 25% of the bank's capital and surplus.[37]

Separate from a national bank's ability to purchase and hold assets under the investment authority of 12 U.S.C. § 24(Seventh) and 12 C.F.R. Part 1, the OCC also has long recognized the ability of a national bank to acquire asset-backed securities representing participation interests in loan pools under a bank's general lending authority, subject to safety and soundness requirements.[38] The purchase of interests as loan participations merely constitutes another way for a bank to engage in permissible lending activities.[39] Under this analysis, the OCC views the purchase of the interests as a purchase of a share of the assets they represent. Significantly,

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[33] Part 1 prescribes standards for national banks engaged in purchasing, selling, dealing in, underwriting, and holding securities, consistent with the authority contained in 12 U.S.C. § 24(Seventh) and safe and sound banking practices. *See* 12 C.F.R. § 1.1.

[34] The rule defines the term "investment grade" to mean a security that is rated in one of the four highest rating categories by either (1) two or more nationally recognized statistical rating organization ("NRSROs"); or (2) one NRSRO if the security has been rated by only one NRSRO. 12 C.F.R. § 1.2(d). By definition, an "investment security" is a marketable debt obligation that is not predominantly speculative in nature. A security is not predominantly speculative in nature if it is rated investment grade. When a security is not rated, the security must be the credit equivalent of a security rated investment grade. 12 C.F.R. § 1.2(e).

[35] 12 C.F.R. § 1.2(n). In this context, "obligor" means the borrowers on the underlying loans backing the security. In contrast, in applying the investment limits to Type V securities, the limit applies to the "issuer" of the security and not each underlying "obligor" on the underlying loans.

[36] 61 Fed. Reg. at 63976.

[37] *See* 12 C.F.R. § 1.3(f). The rule states that in calculating the limits for Type V securities a bank must take into account the Type V securities the bank is legally committed to purchase or sell in addition to the bank's "existing holdings." Section 1.4(d) clarifies that aggregation requirements apply separately to Type III and Type V securities. However, in the rule's preamble the OCC cautions that credit concentrations in excess of 25% from one issuer, but representing different "types" of securities, may raise potential safety and soundness concerns. Similarly, the OCC notes credit concentration standards would be applicable to curtail the amount of a bank's holdings of an issuer's debt obligations that rely on two different sources of authority. *See* 61 Fed. Register at 63979.

[38] Twelve U.S.C. § 24(Seventh) specifically authorizes national banks to discount and negotiate evidences of debt. This authority has long included a national bank's power, using their lending authority, to purchase and hold a variety of debt and debt-like instruments, including certain instruments denominated as securities. *See, e.g.,* OCC Interpretive Letter No. 600 (July 31, 1992).

[39] *See* OCC Interpretive Letter No. 911 (June 4, 2001).

however, bank purchasers relying on their lending authority must adhere to the legal lending limits, the prudential requirements of the OCC as set forth in Banking Circular 181, and other relevant guidance.[40]

*3. 12 C.F.R. Part 3*

The minimum capital adequacy requirements for national bank are codified at 12 C.F.R. Part 3. These rules were first adopted by the OCC in 1985 pursuant to the OCC's general rulemaking authority (12 U.S.C. § 93a) and the International Lending Supervision Act of 1983.[41] These rules contain the requirements and calculations of the minimum regulatory capital requirements for national banks, including the capital treatment of securitization exposures held by national banks. The national bank capital requirements have evolved over the past 25 years reflecting the efforts of the OCC, in conjunction with the other Federal bank supervisory agencies, to make the capital requirements more risk sensitive to activities and risks held by national banks.[42]

Primary and Secondary Capital Requirement. The initial capital requirements adopted in 1985 required banks to maintain two minimum capital ratios: (1) 6 percent total capital (consisting of "primary" and "secondary" capital) to adjusted balance sheet asset and (2) 5.5 percent primary capital to adjusted balance sheet assets.[43] These rules contained no specific provision relating to securitizations.

Risk-Based Capital Guidelines**.** In 1989, the primary and secondary capital requirements[44] were supplemented with the addition of the Risk-Based Capital Guidelines issued by the OCC and the other Federal banking supervisory agencies.[45] The Risk-Based Capital Guidelines implemented in the U.S. the first international Basel agreement on bank capital, often

[40] *See* 12 U.S.C. § 84 and 12 C.F.R. § 32 (statutory and regulatory lending limits for national banks); OCC Banking Circular No. 181 (Rev.), *Purchases of Loans In Whole or In Part-Participations* (Aug. 2, 1984). *See, e.g.,* Interpretive Letter No. 930 (Mar. 11, 2002) (Apr. 2002) (the OCC requires banks to implement "satisfactory controls" over loans, including: [1] written lending policies and procedures governing those transactions; [2] an independent analysis of credit quality by the purchasing bank; [3] agreement by the obligor to make full credit information available to the selling bank; [4] agreement by the selling bank to provide available information on the obligor to the purchaser; and [5] written documentation of recourse arrangements outlining the rights and obligations of each party); *see also* OCC Bulletin 2002-19, *Unsafe and Unsound Investment Portfolio Practices* (May 22, 2002) (recognizing use of lending authority to acquire securities, but emphasizing the need to measure, manage, and control investment risks).

[41] *See* 50 Fed. Reg. 10207 (Mar. 14, 1985).

[42] This section summarizes the OCC rules relating to the capital treatment of securitization exposures where the bank acts as originator or sponsor of the securitization (as opposed to investor). This summary only includes final rulemakings.

[43] *See* 50 Fed. Reg. 10207 (Mar. 14, 1985).

[44] Specifically, the Risk-Based Capital Guidelines provided that mortgage backed securities (MBSs) issued by the government or government-sponsored agency would be risk-weighted according to the risk-weight of the issuer (zero percent for government issuer; 20 percent for government-sponsored agency). Privately issued MBSs would be risk weighted according to the highest risk weight asset in the pool (typically 50 percent for qualifying mortgages). Any subordinated interest (non pro-rata) to a MBS and interest-only or principle-only strips would be risk weighted at 100 percent.

[45] *See* 54 Fed. Reg. 4168 (Jan. 27, 1989).

referred to as Basel I.[46] Under the Risk-Based Capital Guidelines, a bank is required to maintain a minimum capital ratio of total capital (consisting of Tier 1 and Tier 2 capital) to risk-weighted assets of 8 percent.

The Risk-Based Capital Guidelines represented a significant change in the capital requirements for national banks in that, among other things, regulatory capital would be required to be held against off-balance sheet exposures. While recourse and securitization exposures generally would be captured by the Risk-Based Capital Guidelines as either an on-balance sheet asset or an off-balance sheet item, specific provision addressing securitization exposures were limited to mortgage backed securities[47] held by the bank and the treatment of assets sold with recourse. Under the Risk-Based Capital Guidelines, the full amount of an asset or a pool of assets sold with recourse remained on the balance sheet of the bank and was subject to the capital charge as if the asset were not sold (essentially a 100 percent credit conversion factor for off-balance sheet items and a credit risk weight based on the type of asset).

<u>Insignificant Recourse Rule.</u> In 1992, the OCC revised the capital treatment of assets sold with recourse to provide an exception for insignificant recourse. Specifically, the amendment provided that an exception to the recourse treatment for certain sales of mortgage loan pools with less than significant risk of loss, provided that the bank has not retained any significant risk of loss, the maximum contractual exposure is less than the amount of probable loss, and the bank creates a special reserve to cover the maximum contractual exposure.[48]

<u>Low Level Recourse Rule</u>. In 1995, the OCC amended the Risk-Based Capital Guidelines to adopt the Low Level Recourse Rule as required by the Riegle Community Development and Regulatory Improvement Act of 1994. Generally, under the Low Level Recourse Rule, where the amount of recourse liability retained by a bank is less than the capital requirement for the credit exposure, the amount capital that a bank must hold is limited to the amount of the bank's maximum contractual exposure under the recourse obligation.[49]

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[46] *See* International Convergence of Capital Measurement and Capital Standards (July 1988).

[47] The primary and secondary capital ratio was subsequently replace in 1990 with the now current Tier 1 Leverage Capital Ratio which essentially requires a bank to maintain a Tier 1 capital to adjusted total assets of 4 percent (or alternatively, 3 percent for banks with a composite CAMELS rating of 1). *See* 55 Fed. Reg. 38797 (Sept. 21, 1990).

[48] *See* 57 Fed. Reg. 44078 (Sept. 24, 1992). The OCC rule represented a clarification, and not a change, of the existing treatment of recourse arrangements under the risk-based capital guidelines. See discussion at 57 Fed. Reg. 44078, 44083 (Sept. 24, 1992). The rule was generally consistent with the Federal Reserve's treatment of recourse exposures. *See* 56 Fed. Reg. 51151 (Oct. 10, 1991).

[49] *See* 60 Fed. Reg. 17986 (April 10, 1995). As required by CDRI, the Low Level Recourse Rule was also adopted by the other Federal bank supervisory agencies in separate rulemakings. *See* 60 Fed. Reg. 8177 (Feb. 13, 1995) (Board); 60 Fed. Reg. 15858 (March 28, 1995) (FDIC). The OTS's rules already contain a low level recourse provisions so no rulemaking was necessary. *See* 66 Fed. Reg. 59614, 59615 (November 29, 2001). The Federal bank supervisory agencies' low-level recourse rules appeared at: 12 CFR 3, appendix A, section 3(d) (OCC); 12 CFR 208, appendix A, section III.D.1.g and 225, appendix A, section III.D.1.g (FRB); 12 CFR 325, appendix A, section II.D.1 (FDIC); and 12 CFR 567.6(a)(2)(i)(C) (OTS). *See* discussion at 65 Fed. Reg. 57993, 57996 (Note 10) (Sept. 27, 2000). These provisions were later incorporated into the Federal bank supervisory agencies' joint rulemaking on recourse and direct credit substitutes. *See* 66 Fed. Reg. at 59617.

Small Business Loan Recourse Rule**.** In 1995, the OCC and the other Federal bank supervisory agencies issued an interim rule to amend the Risk-Based Capital Guidelines to adopt the Small Business Loan Recourse Rule as required by the Community Development and Regulatory Improvements Act of 1994. Specifically, the Small Business Loan Recourse Rule generally provided an alternative capital charge based on the amount of the retained recourse for small business obligations transferred with recourse for certain well capital banks that establishes a non-capital reserve sufficient to cover the estimated liability under the recourse arrangement up to an aggregate limit of 15 percent of the bank's total capital.[50]

Recourse Rule In 2001, the OCC and the other Federal bank supervisory agencies issued the "recourse" rule, which amended the Risk-Based Capital Guidelines to add provisions specifically on the treatment of securitization exposures retained in connection with a bank's securitization activities. As part of the securitization process, banks often retain subordinate securities which act as credit enhancement to the senior securities sold to investors. Under the Recourse Rule, banks may apply the "ratings based approach" specified in the rule to qualifying retained securitization exposures. The ratings-based approach assigns risk weights ranging from 20 percent (for triple-A ratings) to 200 percent (for double-B ratings), depending on the rating. A securitization exposure rated below double-B does not qualify for the ratings-based approach and is assigned a dollar-for-dollar capital charge that approximates a 1,250 percent risk weight.[51]

The adoption of the Recourse Rule represented a significant increase in the risk sensitivity of the current Risk-Based Capital Guidelines (which reflected the Basel I international capital framework) with respect to securitization exposures. The principles developed in the US capital treatment for securitization exposures in the Recourse Rule would later serve as the basis, with some enhancement, for the securitization framework in the Basel II international capital framework.

Asset-Backed Commercial Paper ("ABCP") Rule. In 2003, the OCC and the other Federal bank supervisory agencies issued an interim final rule that addressed the consolidation of ABCP program assets and liquidity facilities to ABCP conduits. Specifically, the ABCP rule allowed sponsoring banks to remove consolidated ABCP program assets from their risk-weighted assets for the purpose of calculating their risk-based capital ratios. Under the ABCP Rule, sponsoring banks were required to hold capital against all other risk exposures arising in connection with ABCP programs.[52] The exception to consolidation of ABCP program assets was eliminated in 2010.[53] Consequently, following a transition period, the consolidated assets of an ABCP program will be reflected in a bank's risk-based capital ratios.

Under the Risk-Based Capital Guidelines, long-term liquidity facilities with an original maturity of over one year were converted to an on-balance sheet credit equivalent amount using the 50 percent credit conversion factor. Short-term liquidity facilities with an original maturity of one year or less were converted to an on-balance sheet credit equivalent amount utilizing the zero percent credit conversion factor, which result in no capital charge. In the final ABCP Rule,

[50] *See* 60 Fed. Reg. 47455 (Sept. 13, 1995); 62 Fed. Reg. 55490 (Oct. 24, 1997).

[51] *See* 66 Fed. Reg. 59614 (Nov. 29, 2001).

[52] *See* 68 Fed. Reg. 56530 (Oct. 1, 2003); 69 Fed. Reg. 44908 (July 28, 2004) (Final Rule).

[53] *See* 75 Fed. Reg. 4636 (Jan. 28, 2010).

the OCC and other Federal bank supervisory agencies revised the capital treatment of liquidity facilities. Specifically, under the ABCP Rule, subject to an asset quality test, long-term facilities receive a credit conversion factor of 50 percent, and short term facilities receive a credit conversion factor of 10 percent. If the asset quality test is not met, the liquidity facility is subject to a 100 percent credit conversion factor.

Basel II Advanced Approaches Rule. In 2007, the OCC and the other Federal bank supervisory agencies supplemented the current capital rules with the addition of the Basel II Advanced Approaches Rule, which implemented in the U.S. the Basel revised capital framework, often referred to as Basel II.[54] The Basel II Advanced Approaches Rule represented a significant change in the capital requirements for certain internationally active banks in that regulatory capital requirement for these banks generally is based on an advanced internal ratings-based approach for credit risk and an advanced measurement approach for operational risk. With respect to securitization exposures, under the Basel II Advanced Approaches Rule, gain-on-sale and credit enhancing interest only strips, which are often recognized or retained by an issuing bank, are deducted from capital. Banks must apply a ratings-based approach to qualifying retained securitization exposures that are not already deducted that is similar to the capital treatment under the Recourse Rule provided in the Risk-Based Capital Guidelines. Under the Risk-Based Capital Guidelines, the capital treatment for retained exposures that are not eligible for the ratings-based approach may be modeled if there is sufficient information. However, generally, the modeling alternatives are equal to or harsher than the treatment provided under the ratings-based approach. If a bank does not use any of the treatments described above, it must deduct the exposure from capital.[55]

[54] *See* International Convergence of Capital Measurement and Capital Standards: A Revised Framework (June 2006).

[55] *See* 72 Fed. Reg. 69288 (Dec. 7, 2007).

# LISTING OF ATTACHMENTS TO APPENDIX D

## Select OCC Interpretive Letters

Letter from Robert Bloom, Acting Comptroller of the Currency, to Bank of America (Mar. 29, 1977)

Letter from Robert L. Clarke, Comptroller of the Currency, to the Honorable Alfonse M. D'Amato, United States Senate (June 18, 1986)

OCC Interpretive Letter No. 388 (June 16, 1987)

OCC Interpretive Letter No. 418 (Feb. 17, 1988)

## Select OCC Supervisory Guidance

OCC Comptroller's Handbook, *Asset Securitization* (Nov. 1997)

OCC Bulletin 99-46 (December 1999), *Interagency Guidance on Asset Securitization Activities*

OCC Bulletin 2007-1 (January 2007), *Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities*

DocDate: March 29, 1977

Type: Letter

Author: Bloom, Robert, Acting Comptroller of the Currency

Addressee: (Illegible Lines)

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Dear Mr.(Illegible Word)

This is in response to a letter dated December 22, 1976, from(Illegible Words) Bank of America, to Ford Barrett, Assistant Chief Counsel of the Office of the Comptroller of the Currency, concerning the bank's mortgage backed securities proposal.

On June 1, 1976, the Comptroller's Office approved the issuance of mortgage backed bonds by a trust to which Bank of America would sell without recourse uninsured single family residential real estate loans. At that time, the Office expressed the opinion that the bank's proposal would not violate section 20 of the Glass-Steagall Act (12 U.S.C. 377), which bars member banks from being affiliated as described in 12 U.S.C. 221a with an entity engaged principally in the issue, flotation, underwriting, public sale or distribution of securities. It was also determined that the proposal is not prohibited by section 21 (12 U.S.C. 378), which prohibits institutions "in the business of receiving deposits" from engaging simultaneously "in the business of issuing, underwriting, selling, or distributing" securities.

Following the Comptroller's approval, the bank sought the views of the Federal Reserve Board on the imposition of reserve requirements, measured either by the bank's or the trust's liability on the stand-by letter of credit used to provide more "comfort" to investors or by the proceeds received from the sale of loans to the trust. During these discussions, the use of a trust as issuer of the securities was eliminated, and the security itself was changed from a bond type instrument to a passthrough type patterned as closely as possible after the fully modified Ginnie Mae security which has received regulatory approval and wide acceptance in the marketplace. Under the modified proposal, the pool of conventional residential mortgages serving as collateral would be segregated from the bank's existing mortgage portfolio and held by another California bank, which would function both as custodian of the mortgage documents and as trustee to represent the interests of security holders. Third party insurance against losses on the mortgages would be obtained by the bank in an amount initially equal to 5% of the aggregate outstanding principal amount of the mortgages in the pool.

In view of the modifications, the only Glass-Steagall question is whether the bank would be engaged in the business of issuing, underwriting, selling or distributing securities within the meaning of section 21.

While the guideposts in the legislative history of the Glass-Steagall Act on the question of the extent to which banks may issue securities without becoming engaged "in the business" of issuing, etc., securities are few, common sense and observation of industry practice tell us that banks can issue securities frequently without being considered "in the business" of issuing securities in the same sense as investment bankers. For example, banks issue their own securities in the form of equity and debt, and engage every day in the sale of certificates of deposit and loan participations, both of which can be considered securities in certain contexts. n1 Thus, notwithstanding the statute's broad language, the frequent issue or sale of securities does not in itself mean that the issuing bank is engaged "in the business" of issuing securities. Rather, we think whether the bank is issuing or selling securities on behalf of another issuer, whether the issuance or sale of the securities in question constitutes a vital part of the bank's overall business, and the manner in which the securities are sold are important considerations. n2

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n1 See, e.g., Garner v. Pearson, 374 F. Supp. 591, 596 (M.D. Fla. 1974) (certificate of deposit); Lehigh Valley Trust Co. v. Central Nat'l Bank of Jacksonville, 409 F.2d 989 (5th Cir. 1969) (loan participation). But see Burrus, Cootes & Burrus v. MacKethan, 537 F.2d 1262 (4th Cir. 1976) (certificate of investment), opinion withdrawn on rehearing but judgment affirmed, No. 75-2130, Dec. 10, 1976.

n2 Some of the same factors were used by the Federal Reserve Board in concluding that the issuance and sale of "thrift notes" by a bank holding company violated the Glass-Steagall Act. 12 CFR 250.221. On the other hand, commercial banks routinely issue Ginnie Mae securities, and federal savings and loan associations have been authorized to issue mortgage backed bonds. No one has suggested that the issuance of these securities raises any problems under the Glass-Steagall Act.

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In this case, Bank of America is not issuing, selling or distributing securities on behalf of another issuer. The securities represent the sale of an interest in bank assets, conventional mortgage loans. Significantly, Section 21 of the Act contains a specific provision which states, "Provided further, That nothing in this paragraph shall be construed as affecting in any way such right as any bank, banking association, savings bank . . . may otherwise possess to sell, without recourse or agreement to repurchase, obligations evidencing loans on real estate." It is our opinion that Bank of America's proposal fits precisely within this statutory language. Indeed, this language underscores the evident intent of Congress not to disturb the secondary market for real estate loans made by financial institutions.

Moreover, while the sale of mortgage-backed securities will furnish another means to liquify long term loans, thereby enabling the bank to make more mortgage loans, it hardly represents a principal element of the bank's line of business. Unlike an investment banking firm for which the issue, sale and distribution of securities is a sine qua non, Bank of America's banking business will not be substantially affected either by the issue and sale of mortgage-backed securities or by the bank's failure to undertake such an issue and sale. Finally, the actual issuance of the securities is being accomplished through an investment banking firm acting as underwriter, and sales will be made only to sophisticated customers in denominations of $ 100,000 or more.

In light of these factors, we believe that, under the bank's plan, the issuance and sale of mortgage-backed securities on a quarterly basis will not violate Section 21 of the Glass-Steagall Act, 12 U.S.C. 378.

The bank's proposal raises questions concerning the application of 12 U.S.C. 82, which limits the borrowings of a national bank. In our letter of June 1, 1976, we viewed the transaction as a sale of assets. The same rationale is applicable to the revised proposal. While the bank is permitted to make advances irrespective of receipts from obligors on notes in the pool and would have the option to purchase defaulted loans from the pool, these rights (both of which are normal in connection with Ginnie Mae securities) would be limited to advances and purchases covered by third-party insurance. Thus, the availability of the insurance coverage enables the bank to avoid the risk associated with the underlying assets. Moreover, the bank is prohibited from exchanging or substituting mortgages in its portfolio for mortgages in the pool once the pool has been established.

These arrangements lead us to conclude that the transaction is a bona fide sale of assets, with the bank retaining no risk on the underlying mortgages. Accordingly, 12 U.S.C. 82 is not applicable.

We trust the above, together with our letter of June 1, 1976, is sufficiently responsive to the issues raised by the bank's proposal.

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

June 18, 1986

The Honorable Alfonse M. D'Amato
Chairman
Subcommittee on Securities
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator D'Amato:

In response to your June 3, 1986 inquiry, this letter contains the Office of the Comptroller of the Currency's ("Office") legal analysis regarding the May 22, 1986 no-objection letter written in response to a request from Liberty Norstar Bank, N.A., Buffalo, New York ("Liberty Norstar" or "Bank"). As indicated in our June 10, 1986 letter to you, the May 22 letter was based on a long line of precedents which recognize that national banks may transfer their mortgage and mortgage-related assets in transactions substantially similar to those in question.

The Office has taken the view that a collateralized mortgage obligation (cmo), in the broadest sense, is a bond or other obligation or evidence of indebtedness representing the transfer of an interest in an underlying mortgage, pool of mortgages or mortgage-related obligations. A bank generally uses cmos as a source of liquidity in conjunction with its ownership of mortgage assets; this enables an issuing bank to obtain funds for additional lending activities.

The transfer of a cmo by a bank can be characterized in a number of ways--as a sale of an interest in real estate obligations, as a borrowing, or as the receipt of a deposit. Since at least 1976, 1/ this Office has recognized the

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1/ In fact, the Office first approved the sale of interests in GNMA-insured loans in 1970. See Banking Circular No. 24
(Footnote continued on next page)

legitimacy of national bank transfer--or issuance and sale--of mortgage backed instruments to their customers and to the public. In a 1977 interpretive letter, the Office stated:

> The sale of mortgage backed instruments will provide a commercial bank another means of adding liquidity to its long term conventional mortgage portfolio. Instead of holding these mortgages, the bank will in effect sell them, thereby generating more funds to make more mortgage loans. . . . The net effect of the proposal, therefore, is to bring additional funds into the home mortgage market.

OCC Press Release of March 30, 1977 and letter from Robert Bloom, Acting Comptroller of the Currency, to Leland S. Prussia, Fed. Banking L. Rep. (CCH) ¶ 97,093. 2/

The letter recognized that banks regularly issue equity and debt securities to raise funds and purchase and sell on a daily basis deposits and loans, and interests therein. The Office acknowledged that the proposed activity could constitute the issuance of securities, but determined that the activity did not constitute engagement "in the business" of issuing securities "in the same sense as investment bankers". Instead, the Office viewed the securities to "represent the sale of an interest in bank assets, conventional mortgage loans." Id. Support for the ability of national banks to sell obligations evidencing mortgage-related interests was found in explicit language contained within Section 21 of the Glass-Steagall Act, 12 U.S.C. § 378(a)(1) ("Glass-Steagall" or "Act"):

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(Footnote continued from previous page)
(April 16, 1970). Section 16 of the Glass-Steagall Act, 12 U.S.C. § 24 (Seventh), explicitly authorizes bank "underwriting" of issues guaranteed by the Government National Mortgage Association ("GNMA"), the Federal National Mortgage Association ("FNMA") and the Federal Home Loan Mortgage Corporation ("FHLMC").

2/ The March 30, 1977 letter approved Bank of America's issuance of mortgage backed securities representing interests in conventional loans from the bank's portfolio. While it was initially contemplated that the securities would be sold only to institutional investors, the plan of distribution was broadened to include sales to the public.

> Significantly, Section 21 of the Act contains a specific provision which states, "Provided further, that nothing in this paragraph shall be construed as affecting in any way such right as any bank, banking association, savings bank . . . may otherwise possess to sell, without recourse or agreement to repurchase, obligations evidencing loans on real estate." It is our opinion that Bank of America's proposal fits precisely within this statutory language. Indeed, this language underscores the evident intent of Congress not to disturb the secondary market for real estate loans made by financial institutions. 3/

Id. The Office's determination that the sale of mortgage backed securities was in effect the sale of a national bank's mortgage-related assets provided the basis for a substantial series of precedents, each recognizing a variant of the activity approved in the Bank of America letter, supra. In each of the precedents mentioned below, the bank was either selling interests in some of its mortgages or its mortgage-related assets, or it was borrowing money, using those assets as collateral. See, e.g., February 14, 1978 letter from Charles B. Hall, Deputy Comptroller for Banking Operations, Fed. Banking L. Rep. (CCH) ¶ 85,100 (permitting bank employees, rather than underwriters, to market the mortgage backed obligations); May 18, 1978 letter from John G. Heimann, Comptroller of the Currency, Fed. Banking L. Rep. (CCH)

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3/ While the proviso to Section 21 was a technical amendment, enacted without comment as part of the Banking Act of 1935, there is ample evidence in the legislative history indicating that the 1935 Congress was concerned with increasing banks' real estate loan activities in order to promote the development of an organized, secondary mortgage market. For example, in the House Report's discussion of a provision intended to liberalize the limitations on bank real estate lending, it is stated that this provision was intended to "increase the ability of the banks to serve their communities, to provide a greater outlet for the banks' funds, and to promote business recovery by opening up the mortgage market and reviving the construction industry." H.R. Rep. No. 742, 74th Cong., 1st Sess. 14 (1935). It was also noted in this Report that real estate loans had suffered historically as compared with other loans because "there was no organized market where they could be sold even at a reduced value." Id. at 15.

¶ 85,116 (permitting a national bank's trust division rather than an independent trustee to serve as trustee for the mortgage pool and deleting the requirement that the transaction be treated as a sale for tax purposes); October 17, 1978 letter from H. Joe Selby, Deputy Comptroller for Operations, Fed. Banking L. Rep. (CCH) ¶ 85,144 (concerning collateral trust certificates); April 20, 1979 letter from Paul M. Homan, Senior Deputy Comptroller for Bank Supervision, Fed. Banking L. Rep. (CCH) ¶ 85,167 (permitting the sale of two classes of certificates, with the result that Class B certificateholders would not receive the "passed-through" mortgage payments and interest until full payment had been made to Class A certificateholders; permitting the creation of a "reserve fund" at the Bank against risk of default; recognizing that this activity might constitute a bank borrowing of funds); July 31, 1979 letter from John M. Miller, Deputy Chief Counsel, Fed. Banking L. Rep. (CCH) ¶ 85,182 (permitting the formation of a conduit mortgage company to package loans made by participating banks); February 1, 1980 letter of Paul M. Homan, Senior Deputy Comptroller for Bank Supervision, Fed. Banking L. Rep. (CCH) ¶ 85,213 (permitting national bank to use its standby letter of credit rather than mortgage insurance to insure against risk of default, with recognition that the retained risk made this activity a borrowing for purposes of 12 U.S.C. § 82); July 9, 1980 letter from Ford Barrett, Assistant Chief Counsel, Fed. Banking L. Rep. (CCH) ¶ 85,226 (12 U.S.C. § 82 considered not applicable to voluntary advance feature for standby letter of credit); May 29, 1981 letter from Billy C. Wood, Deputy Comptroller, Multinational Banking, Fed. Banking L. Rep. (CCH) ¶ 85,275 (inclusion of second mortgages in mortgage pools). See also October 3, 1979 letter from the Federal Reserve Board, Fed. Banking L. Rep. (CCH) ¶ 98,013 (permitting the replacement of third-party mortgage insurance with a standby letter of credit for purposes of Regulation D); October 5, 1979 letter from Federal Reserve Board, Fed. Banking L. Rep. (CCH) ¶ 98,014 (permitting the inclusion of loans which would mature within five years, even though the bank had committed to make a new loan to each mortgagor not in default).

The basis for these determinations was further articulated in the April 12, 1983 letter of Chief Counsel Brian W. Smith, Fed. Banking L. Rep. (CCH) ¶ 85,421. The Smith letter described the Office's view that bank-issued pass-through certificates and the pool containing the underlying loan obligations were "legally transparent" since the certificateholders had essentially . . . (through an undivided interest in the underlying obligations held by a trustee) . . . the same rights, liabilities and risks as if they were the direct owners of the loans." Chief Counsel Smith referred to the specific exemption for FHA-insured mortgages contained in Section 16 of the Glass-Steagall Act, 12 U.S.C. § 24 (Seventh). However, he also referred to the Office's long-held position that Section 21 "clearly authorizes national banks to purchase and sell real estate loans, as well as pass-through certificates representing such loans." This reiterated the Office view, stated in the earlier precedents, that the transfer of interests in a pool of conventional mortgage loans or obligations from a national bank's portfolio is an authorized activity, not prohibited by the Glass-Steagall Act. Thus, for Glass-Steagall purposes, the Office stated that the sale of the interests did not alter the character of the transaction--the bank's sale of instruments in its mortgage-related portfolios.

It is clear from these precedents that the Office's determinations have rested squarely on relevant statutory language in the national banking laws and the Glass-Steagall Act. First, as previously stated, Section 16 of the Glass-Steagall Act authorizes a bank's activity with regard to the GNMA, FNMA and FHLMC obligations. Moreover, national banks may raise funds by selling interests in their mortgage-related assets, thereby assuring adequate liquidity for continued mortgage origination and investment. In fact, for accounting purposes the cmo sale may be a straightforward sale of interests in the bank's assets, or it may represent a borrowing collateralized by some of the bank's assets. 4/ See, e.g., Fed. Banking L. Rep. (CCH) ¶¶ 85,116, 85,167 and 85,213, supra. In some instances, the transfer of a bank's interest in mortgage-related obligations is permissible not merely because the bank may sell these obligations pursuant to Section 21, but because it has long been recognized that national banks have the power to borrow funds. 5/ In those instances where a bank's sale of cmos represents the bank's borrowing of funds, the Glass-Steagall prohibitions are inapplicable. Borrowing is

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4/ As stated in our May 22 letter, Liberty Norstar has taken a number of steps to ensure that the transaction is not a reservable deposit for purposes of Regulation D. In this regard, see the Regulation D analyses contained in the previously cited Office and Federal Reserve Board precedents. In any event, even where alterations in the structure of the transaction result in certain legal distinctions, these differences are not germane for purposes of the Glass-Steagall analysis.

5/ See, e.g., Wyman v. Wallace, 201 U.S. 230, 243 (1906); Aldrick v. Chemical National Bank, 176 U.S. 618, 626-628 (1900); Auten v. United States National Bank, 174 U.S. 125, 141-143 (1899).

an incidental bank power--a traditional power, "necessary to carry on the business of banking." See Securities Industry Association v. Board of Governors of the Federal Reserve System, 468 U.S. 137, 158 n.11 (1984) ("Becker"). More generally, it is unquestioned that national banks can sell their assets. If banks were unable to achieve adequate liquidity through transactions in the relevant market when economic conditions and safety and soundness concerns so dictated, the consequences could be serious. In summary, a bank's ability to obtain funds--through a borrowing or sale based upon the bank's transfer of interests in its mortgage-related obligations to the secondary mortgage market--is essential to the bank's role in the real estate and housing markets and its ability to conduct its business generally. See, e.g., supra note 3.

The Liberty Norstar proposal does not differ in any material respect from the previously cited Office precedents. The May 22, 1986 no-objection letter does not extend the prior approvals to incorporate new kinds of loans or obligations. It does provide that in some instances an underlying pool will be mixed, in that it may consist of a combination of whole conventional mortgages from the Bank's portfolio and GNMA, FNMA and FHLMC mortgage certificates, rather than a pool containing only a single kind of mortgage obligation. 6/

In addition, in some instances the pass-through would be a double layer pass-through, since bond purchasers would have an interest in certificates representing interests in Government insured mortgage loans. However, because in every case the trustee would be the record owner of all certificates, the application of the Office's Section 21 pass-through rationale is proper. The trustee's ownership of the certificates is governed by the provisions of an indenture filed in accordance with the requirements of the Trust Indenture Act, which would require the trustee to seek payments from the appropriate guarantor on behalf of the bondholders. Therefore, bondholders would have "essentially . . . the same rights, liabilities and risks as if they were the direct owners of the loans." See Smith letter, supra.

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6/ In any instance in which the underlying pool is mixed, the Bank has agreed to ensure that the pool meets all requirements of the Section 3(c)(5)(C) exemption from the Investment Company Act of 1940 for entities "primarily engaged in [the business of] . . . purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." Thus, the Bank will not be affiliated with an investment company.

The May 22, 1986 letter does not conflict with the language or purpose of the Secondary Mortgage Market Enhancement Act of 1984, Public Law No. 98-440, Title 1, § 105(c), 98 Stat. 1691 (1984) ("Mortgage Act") because the activity in question amounts only to a transfer by the Bank of its own mortgage assets and obligations. The Mortgage Act amended Section 16 of the Glass-Steagall Act to permit bank investment in privately insured mortgage obligations originated by "financial institutions", enabling banks to invest in mortgage-backed securities representing interests in the mortgage portfolios of other financial institutions. Thus, the Mortgage Act enhanced the investment power of banks without affecting their pre-existing authority to sell interests in loans and other mortgage-related obligations from their own portfolios. 7/

In summary, we wish to assure you that the Liberty Norstar letter is based on long-standing precedents and is consistent with applicable law. 8/ The banking system must be able to

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7/ Proposed provisions for banks to underwrite and deal in the mortgage backed securities of qualified "financial institutions" were deleted from the legislation. However, the legislation also was based on the recognition that for at least a decade banks had sold their own mortgage backed securities. See, e.g., Secondary Mortgage Market Enhancement Act of 1983: Hearings on S. 1821, S. 1822 and S. 2040 Before the Subcommittee on Housing and Urban Affairs of the Senate Committee on Banking, Housing, and Urban Affairs, 98th Cong., 1st Sess. 319 (1983), where the Congressional Research Service stated: "The first publicly offered direct PC [participation certificate] issue, for $150 million, was made by the Bank of America in 1977"; id. at 226, the statement by Preston Martin, Vice Chairman, Board of Governors of the Federal Reserve System: "While a fair number of banks, thrift institutions, mortgage companies, insurance companies and so-called conduit organizations have issued private pass-throughs. . . ."

8/ Becker, supra, and the "IRA cases" support the activity in question. In Becker, the Supreme Court explicitly recognized that Glass-Steagall was not intended to interfere with those banking powers "necessary to carry on the business of banking." Becker, 468 U.S. at 158 n.11. In scrutinizing the creation of bank collective investment trusts for the assets of IRA trusts, the courts have largely recognized, in reliance on Investment Company Institute v. Camp, 401 U.S. 617 (1971), that a bona fide bank fiduciary activity was not prohibited under the Glass-Steagall Act. See, e.g., Investment Company Institute v. Conover, No. 85-5019 (D.C. Cir. May 20, 1986); Investment Company Institute v. Clarke, No. 86-6033 (2d Cir. May 2, 1986), aff'g 630 F. Supp. 593 (D. Conn. 1986).

engage in prudent funds management policies in connection with bank assets and liabilities and generate or maintain adequate liquidity in the course of providing long-term, often fixed-rate real estate and housing finance. We are sure you will agree that the Glass-Steagall Act was never intended to interfere with these activities. The Office's May 22, 1986 no-objection letter follows from the long-standing recognition that national banks can obtain funds from time to time through borrowing or sales transactions based upon some of their underlying mortgage-related assets. In our view, the powers conferred by the national banking laws including 12 U.S.C. § 24 (Seventh), the proviso to Section 21 of the Act, the authority of national banks to borrow funds, and a long line of published Office precedent, support the result we reached in the Liberty Norstar matter. We trust that our reasoning will resolve your concerns about the May 22 letter.

Sincerely yours,

Robert L. Clarke
Comptroller of the Currency

Enclosure

DocDate: June 16, 1987

Type: Letter

Subject: Interpretive Letter #388

Author: Clark, Robert L., Comptroller of the Currency

Addressee: Freeman, Russell A., Executive Vice President and General Counsel Security Pacific National Bank, P.O. Box 60468 Los Angeles, California 90060

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Dear Mr. Freeman:

This responds to your June 12, 1987 request on behalf of Security Pacific National Bank ("Bank"). In your letter, you ask that we provide you with a copy of our response to the letter of April 2, 1987 from the Securities Industry Association ("SIA") for a determination that the Glass-Steagall Act ("Act") prohibits the Bank from selling mortgage-backed pass-through certificates evidencing interests in pools of its conventional mortage loans, as described in the Bank's Prospectus and Prospectus Supplement, dated January 23, 1987. You state that the Bank is requesting a copy of our response so that it may conduct its activities in accordance with our determination. Because this Office is the primary regulator of the Bank's activities, however, we have determined to respond directly to the Bank concerning the SIA's inquiry.

We have reviewed the offering materials and have concluded that the Bank's program n1 is authorized under the national banking laws and is substantially in accord with a long line of OCC precedents recognizing that the Glass-Steagall Act does not restrict the means by which national banks may sell or transfer interests in, among other assets, their mortgage and mortgage-related assets.

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n1 We have also consulted the Bank's counsel, to obtain clarification of certain technical aspects of the Bank's program.

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According to the Bank's Prospectus, a separate series of mortgage-backed pass-through certificates ("Certificates") will be issued in connection with each mortgage pool. n2

Each mortgage pool will be composed of mortgages originated by the Bank in the ordinary course of its mortgage lending activities. Upon the issuance of a certificate series, the Bank will assign the loans in the mortgage pool without recourse to a trustee for the benefit of the Certificateholders. Each Certificate will represent a fractional undivided interest in the trust property, which will consist solely of the mortgage loans in the pool for that series and certain related property, including mortgage payments awaiting distribution, property acquired by foreclosure or otherwise, and the Certificateholders' interest in any insurance policies maintained with respect to the mortgage loans. n3

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n2 The details concerning each series of Certificates will be contained in a Prospectus Supplement to be prepared in connection with each series.

n3 While the SIA's letter designates the Bank's program as involving a "distribution of collateralized mortgage obligations," that description is not technically correct. A collateralized mortgage obligation ("CMO") is a specialized mortgage-backed obligation, or bond, that is typically issued in a series of classes, with each class having an expected maturity different from the loans in the underlying mortgage pool. This serialization provides a degree of protection to investors against the risk of early maturity. See Financial Accounting Standards Board (FASB) Technical Bulletin 85-2: Accounting for Collateralized Mortgage Obligations, March 18, 1985. See also Smith and D'Annolfo, Collateralized Mortgage Obligations: An Introduction, 16 Real Estate Review 30-42 (Spring 1986). This Office has permitted national banks to transfer interests in their mortgage assets through the use of CMO's in a variety of transactions. See, e.g., March 24, 1987 letter of Emory W. Rushton, Deputy Comptroller for Multinational Banking, [Current Developments] Fed. Banking L. Rep. (CCH) P85,602; June 18, 1986 letter of Robert L. Clarke, Comptroller of the Currency, to Senator Alphonse M. D'Amato; May 22, 1986 letter of Richard V. Fitzgerald, Chief Counsel, [1985-87 Transfer Binder] Fed. Banking L. Rep. (CCH) P85,532.

The Bank's program, by contrast, involves a simple pass-through certificate, which represents an undivided ownership interest in the underlying pool of mortgage loans. Pass-through certificates are designed to closely resemble the underlying mortgages with respect to the timing and amount of principal and interest payments. All of the risk of uncertain maturity due to prepayments is borne by the purchasers of the certificates, as if they were the owners of the mortgages.

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Under a pooling and servicing agreement to be entered into with each trustee, the Bank will service the mortgages and receive a fee for this service. Distributions of principal and interest at the pass-through rate n4 will be made by the Bank, as agent for the trustee, to the Certificateholders each month. The Prospectus Supplement contains a boldface statement that the Certificates are not obligations of the Bank or its parent, Security Pacific Corporation, and that neither the Certificates nor the underlying mortgage loans are insured or guaranteed by the Federal Deposit Insurance Corporation, the Government National Mortgage Association, or any other governmental agency or entity.

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n4 The pass-through rate is equal to the weighted average interest rate of the mortgage loans as of the first day of the month of the creation of the trust, less the servicing compensation payable to the Bank.

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Credit support for each series will be provided by a Bank-issued standby letter of credit or a limited guaranty to be issued by Security Pacific Corporation or some entity other than the Bank, and/or pool insurance to be obtained by the Bank as servicer of the loans.n5 In those instances where the Bank elects to provide its own letter of credit, the letter of credit will be issued pursuant to established credit criteria, in accordance with the Bank's normal credit extension practices. Credit coverage will be provided up to the amount specified in the Prospectus Supplement, but in no event will that coverage be more than 10% of the initial aggregate principal balance of the subject mortgage pool. Provision is made for the Bank to make reimbursable voluntary monthly advances to the pool if delinquencies on the underlying mortgages cannot be covered from the funds available for distribution, but only to the extent of the amounts available under the limited guaranty or pool insurance. All risks of delinquency and loss resulting from defaults on the underlying mortgage loans that are not covered by the applicable credit support will be borne by the Certificateholders.

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n5 Security Pacific Corporation is providing the limited guaranty for the certificate series described in the Prospectus Supplement dated January 23, 1987.

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Under generally accepted accounting principles, regulatory accounting principles and for other bank regulatory purposes, the Bank will account for the transaction as a sale of assets. See FASB Statement of Financial Accounting Standards No. 77: Reporting by Transferors for Transfers of Receivables with Recourse, December 1983 (conditions for transfer to be recognized as sale under generally accepted accounting principles); Instructions, Consolidated Reports of Condition and Income for Insured Commercial Banks with Domestic and Foreign Offices, Glossary A-28 (regulatory reporting by issuing bank for privately-issued certificates of participation in pools of residential mortgages) (hereinafter "FFIEC Call Report Instructions"). In no case (other than where the Bank provides its letter of credit, as described herein) n6 will the Bank retain any risk associated with the underlying mortgages. n7

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n6 In any instance where the Bank elects to provide its own standby letter of credit, the Bank will take steps to ensure that the transaction may be reported as a total sale of assets under the FFIEC Call Report Instructions. Additionally, should the Bank provide its own letter of credit, we expect that its obligation would be exempt from the definition of "deposit" under Federal Reserve Board Regulation D, 12 C.F.R. § 204.2(a)(2)(ix), and therefore not a reservable liability.

n7 In order to terminate the pool in an orderly fashion, the Bank has the option (but not the obligation) to repurchase the mortgages when the pool has been amortized to 10% of its initial aggregate principal balance.

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The Certificates are to be sold in a series of public offerings registered by the Bank with the Securities and Exchange Commission. The Prospectus Supplement dated January 23, 1987 names Kidder, Peabody & Co., Inc., as underwriter and provides that this series may also be sold directly to the public by a division of the Bank. Thereafter, the Bank will not buy or sell the Certificates in the secondary market.

The Bank's program closely resembles other national bank transactions involving the sale of interests in mortgage assets, or the pledge of those assets as collateral to support a borrowing, which have received this Office's approval since the mid-1970's. Several national banks, beginning at least with Bank of America in 1977, have been permitted to sell participations in pools of their conventional mortgage loans, i.e., mortgage loans that are not federally insured. See OCC Press Release of March 30, 1977 and letter from Robert Bloom, Acting Comptroller of the Currency, [1973-78 Transfer Binder] Fed. Banking L. Rep. (CCH) P 97,093 (hereinafter "Bank of America Letter"); February 14, 1978 letter from Charles B. Hall, Deputy Comptroller for Banking Operations, id. [1978-79 Transfer Binder] P 85,100; May 18, 1978 letter from John G. Heimann, Comptroller of the Currency, id. P 85,116; October 17, 1978 letter from H. Joe Selby, Deputy Comptroller for Operations, id. P 85,144; April 20, 1979 letter from Paul M. Homan, Senior Deputy Comptroller for Bank Supervision, id. P 85,167; July 31, 1979 letter from John M. Miller, Deputy Chief Counsel, id. P 85,182; February 1, 1980 letter from Paul M. Homan, Senior Deputy Comptroller for Bank Supervision, id. [1981-82 Transfer Binder] P 85,213; May 29, 1981 letter from Billy C. Wood, Deputy Comptroller, Multinational Banking, id. P 85,275.

We have reviewed this Office's previous determinations concerning national banks' sale of assets through offerings of mortgage-backed pass-through certificates and we find that nearly every feature of the Bank's program has met with this Office's prior approval. See

Bank of America Letter, supra (registered public offering underwritten by investment banking firm); Fed. Banking L. Rep. (CCH), supra P 85,100 (permitting bank employees rather than underwriters to market mortgage-backed obligations); id. P 85,116 (permitting bank's trust division rather than an independent trustee to serve as trustee for the certificateholders); id. P 85,213 (permitting national bank to use its standby letter of credit rather than third party mortgage insurance).

The SIA's letter states its view that the Bank's involvement in this transaction violates the Glass-Steagall Act, 12 U.S.C. §§ 24 (Seventh), 78, 377 and 378. We are providing an analysis of this transaction to demonstrate why the SIA's conclusion is incorrect.

In our view, a national bank's issuance of mortgage-backed pass-through certificates evidencing ownership interests in its conventional mortgage assets, of the sort evidenced by the transaction in question, represents nothing more than the negotiation of evidences of debt and the sale of real estate loans, which is expressly authorized under 12 U.S.C. §§ 24 (Seventh) and 371(a). More generally, this transaction involves a sale of bank assets, which is fully permitted under the national banking laws. The fact that the negotiation and sale may be accomplished through the creation and sale by a bank of participation certificates, an activity which this Office long has approved, does not alter in any respect the substance of the transaction, nor its permissibility under the national banking laws.

In language unaltered since the enactment of the National Bank Act in 1864, national banks are granted express authority to "carry on the business of banking; . . . by . . . negotiating promissory notes, . . . and other evidences of debt." 12 U.S.C. § 24 (Seventh). The term "negotiating" authorizes a bank's transfer of its notes or other evidences of debt acquired in the course of the banking business. See Danforth v. National State Bank, 48 F. 271 (3rd Cir. 1891); First National Bank v. Elmer, 278 S.W. 826 (Mo. App. 1926).

The authority for national banks to make mortgage loans and to sell such loans is provided in 12 U.S.C. § 371(a), as follows:

Any national banking association may make, arrange, purchase or sell loans or extensions of credit secured by liens on interests in real estate, subject to such terms, conditions, and limitations as may be prescribed by the Comptroller of the Currency by order, rule, or regulation. n8

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n8 See 12 C.F.R. Part 29 (Adjustable-Rate Mortgages) and Part 30 (Real Estate Loans).

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Even prior to the creation of this express authority for banks to sell their mortgage loans, however, the Supreme Court had already determined that the sale of mortgages and other evidences of debt acquired through a national bank's exercise of its express power to lend money on the security of real estate, and to discount and negotiate other evidences of debt, was authorized as part of the business of banking under 12 U.S.C. § 24 (Seventh). First National Bank of Hartford v. Hartford, 273 U.S. 548, 560 (1927). Thus, it is clearly established that national banks may sell their mortgage assets under the express authority of 12 U.S.C. §§ 24 (Seventh) and 371(a).

For a number of other reasons, also, a national bank's power to sell any of its lawfully acquired assets is clear. The power to sell or transfer interests in one's assets is simply an incident of ownership. Ownership is defined in Black's Law Dictionary 997 (rev. 5th ed. 1979) as the "collection of rights to use and enjoy property, including [the] right to transmit it to others." As with any other corporation, in order to operate effectively, a bank must be able to sell its assets, or interests therein, as economic conditions or safety and soundness considerations warrant. See Fed. Banking L. Rep. (CCH), supra P85,602. If banks were unable to achieve adequate liquidity through sales transactions in the relevant market for their assets, the consequences to the banking system would be serious indeed. See June 18, 1986 letter of Robert L. Clarke, supra. This Office has recognized that a bank's ability to sell interests in its long term mortgage-related portfolio serves specific banking purposes. The ability to sell mortgages which would otherwise be held for twenty or thirty years provides needed liquidity to the mortgage portfolio, resulting in the generation of additional funds for new lending and other purposes. The ability to sell mortgage assets on a regular basis also facilitates management of the maturity mismatch problems inherent in funding long term mortgages with shorter term deposits. See Bank of America Letter, supra.

In short, prudent banking practices may require that banks sell or transfer interests in their assets from time to time. Given the current, troubled condition of the banking industry and certain sectors of the nation's economy, the need for liquidity and the ability to engage in sound asset-liability management practices is all the more important to the maintenance of a safe and sound banking system. See June 18, 1986 letter of Robert L. Clarke, supra.

Thus, there is no doubt that national banks may sell their mortgage assets or any other lawfully acquired assets. Similarly, there can be no legitimate doubt that the national banking laws permit such sales to be accomplished through the issuance and sale of mortgage-backed or other asset-backed certificates. In a recent decision addressing the scope of the "business of banking" under 12 U.S.C. § 24 (Seventh), the District Court for the District of Columbia strongly endorsed the position of this Office that it may "look beyond the label given a certain activity to determine whether or not it is permissible." American Insurance Association v. Clarke, No. 85-1489 (D.D.C. March 10, 1987) ("AMBAC"). The court upheld the Comptroller's determination that a national bank's issuance of standby credit in the form of municipal bond insurance was, in substance, a letter of credit, the issuance of which is a permissible banking practice under 12 U.S.C. § 24 (Seventh). Although neither letters of credit nor municipal bond insurance are specifically enumerated as permissible bank products under the national banking laws, the court recognized that extending credit is a fundamental banking practice which can take a variety of forms, regardless of the label given the activity. The court emphasized that the powers analysis should focus on the substance of the transaction in question and not proceed "from a narrow and artificially rigid view of both the business of banking and the statute that governs that business." Id. at 8.

The AMBAC analysis draws support from the case of M & M Leasing Corp. v. Seattle First National Bank, 563 F.2d 1377 (9th Cir. 1977), cert. denied, 436 U.S. 956 (1978) ("M & M Leasing") in which the Ninth Circuit determined that national banks are authorized under the incidental powers clause of 12 U.S.C. § 24 (Seventh) n9 to lease personal property in circumstances where the lease is "functionally interchangeable" with a secured loan. Id. at 1382-83. In reaching this conclusion, the Ninth Circuit observed that whatever the scope of the powers of national banks, they "must be construed so as to permit the use of new ways of conducting the very old business of banking." Id. at 1382.

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n9 The National Bank Act provides that national banks possess "all such incidental powers as shall be necessary to carry on the business of banking." 12 U.S.C. § 24 (Seventh).

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In view of the foregoing, it is appropriate in this instance to look beyond the Bank's use of the certificate form to the substance of the transaction, which is no more than the lawful negotiation or sale of bank assets. Since this is a permitted activity for national banks, there need not be a separate authorization for the form of the sale. See AMBAC, supra. The use of this form of sale by national banks, since at least 1977, is properly characterized as a "new way" of conducting an established banking practice. See M & M Leasing, supra.

Even if we apply the most restrictive test of "incidental to banking," enunciated in Arnold Tours Inc. v. Camp, 472 F.2d 427, 432 (1st Cir. 1972) ("Arnold Tours"), that for an activity to be authorized as an incidental bank power it must be "convenient or useful" to the performance of an expressly authorized banking power, the process of pooling bank assets and selling certificates representing interests therein can be "convenient or useful" to a bank's ability to sell its assets. n10 As discussed above, national banks are expressly authorized to sell their mortgage assets under 12 U.S.C. §§ 24 (Seventh) and 371(a). This Office has previously recognized that the ability to sell participation interests in pools of mortgage loans provides national banks "a new means of recycling their mortgage dollars." By packaging their mortgage assets for sale in this marketable form, national banks can more easily achieve the liquidity and asset liability management benefits discussed above. See Bank of America Letter, supra; June 18, 1986 letter of Robert L. Clarke, supra. Thus, whether the Bank's use of the mortgage-backed pass-through certificate is viewed as a new way of selling bank assets or as an activity incidental to an authorized banking practice, we are satisfied that the issuance and sale of participation interests in pooled bank mortgage assets is permitted under 12 U.S.C. § 24 (Seventh).

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n10 This Office considers the Arnold Tours test to be overly restrictive, especially in view of the more flexible standards employed by the Supreme Court in construing the incidental powers clause. See, e.g., Merchants' National Bank v. State Bank, 77 U.S. 604, 648 (1871) (whether the activity has grown out of the business needs of the country); First National Bank v. National Exchange Bank, 92 U.S. 122, 127 (1876) (whether the activity is a reasonable and appropriate measure); Wyman v. Wallace, 201 U.S. 230, 243 (1906) (whether the activity is in terms prohibited by the national banking act); Clement National Bank v. Vermont, 231 U.S. 120, 140 (1913) (whether the activity would promote the convenience of the business of banking); Colorado National Bank v. Bedford, 310 U.S. 41, 50 (1940) (whether the activity is a generally adopted method of banks); Franklin National Bank v. New York, 347 U.S. 373, 377 (1954) (whether modern competition finds the activity usual and useful. In AMBAC, the court has indicated even more directly that the "convenient or useful" test may be overly literal and restrictive where the transaction at issue is, in substance, itself an accepted banking practice.

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Because the sale of bank assets through this medium is authorized under the national banking laws, the prohibitions of the Glass-Steagall Act are inapplicable to this transaction. An analysis of the statute confirms that the Bank is not involved in a prohibited securities activity within the meaning of the Act.

As you know, the Glass-Steagall Act was designed in large part to remove commercial banks from the business of investment banking. See generally Banking Act of 1933, Pub. L. No. 73-66, S. Rep. No. 77 to Accompany S. 1631, 730 Cong., 1st Sess. (1933). In so doing, the Act addressed itself primarily to the risks to commercial bank assets and capital posed by bank participation in speculative securities investment and trading activities, as well as to the peculiar "hazards" present in the combination of commercial banking with traditional securities dealing and underwriting activities. There is no suggestion either in the language or legislative history of the Act, however, that it was designed to interfere with lawful banking functions such as the Bank's program discussed herein.

First, the Glass-Steagall Act is not implicated because the Bank's program does not involve a "security" for purposes of the Act. For the following reasons, we do not believe that the pass-through certificates are properly characterized as "securities" within the meaning of the Glass-Steagall Act. n11

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n11 Although the Bank has registered the certificate offering with the Securities and Exchange Commission, this fact, in and of itself, does not determine whether the certificates are securities for Glass-Steagall purposes. See Investment Company Institute

v. Conover, 790 F.2d 925, 933-4 (D.C. Cir.), cert. denied sub nom. Investment Company Institute v. Clarke, __ U.S. __, 107 S. Ct. 421 (1986); Investment Company Institute v. Clarke, 793 F.2d 220 (9th Cir.), cert. denied, __ U.S. __, 107 S. Ct. 422 (1986); Investment Company Institute v. Clarke, 789 F.2d 175 (2d Cir.) (per curiam), aff'd 630 F. Supp. 593 (D. Conn.), cert. denied, __, 107 S. Ct. 422 (1986) (hereinafter collectively cited as the "IRA cases").

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In Investment Company Institute v. Camp, 401 U.S. 617 (1971) ("Camp"), the Supreme Court found that a bank's offering of participation units in a collective fund for managed agency accounts resulted in the illegal distribution of securities under the Glass-Steagall Act. See id. at 624-25. The Court determined that the bank's activity was, in substance, the creation of a mutual fund, which gave rise to all of the "subtle hazards" that Glass-Steagall was designed to prevent. See id. at 634-38. By contrast, in the recent IRA cases upholding the permissibility of national banks' establishing and marketing collective investment trusts for individual retirement account assets (IRAS), the Second Circuit, the Ninth Circuit and the District of Columbia Circuit all concluded that the participation units in the IRA trust funds were not "securities" for purposes of the Act. All courts affirmed the Comptroller's conclusion that these transactions were, in substance, a sale of bank fiduciary services, which did not fall within the purview of the Glass-Steagall Act. See IRA cases, supra.

This Office has previously considered pass-through certificates representing undivided interests in pooled bank assets to be legally transparent for purposes of the Glass-Steagall analysis. In other words, because the certificateholders have essentially the same rights, liabilities, and risks as if they were the owners of the underlying assets, the certificates are considered to be substantially the same as those assets. See April 12, 1983 letter of Brian W. Smith, Chief Counsel, [1983-84 Transfer Binder] Fed. Banking L. Rep. (CCH) P85,421. To the extent that the participation certificates represent "investment opportunities", the opportunity being offered is, in substance, no different than the opportunity of investment in the underlying loans which banks are clearly authorized to sell. See 12 U.S.C. §§ 24 (Seventh) and 371(a). We do not believe that the pooling and packaging of these assets alters the fundamental character of the transaction so as to create a security within the meaning of Glass-Steagall. n12 This conclusion is reinforced by our determination that the Bank's activities do not raise the "subtle hazards" that the Supreme Court has identified as being the focus of Congressional concern in enacting the Glass-Steagall Act. See discussion infra at pages 18-20.

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n12 Our position that mortgage-backed certificates are not securities under the Glass-Steagall Act draws support also from the second proviso to Section 21 of the Act, 12 U.S.C. § 378(a)(1), where Congress has indicated its clear intent not to disturb the secondary market for real estate loans made by financial institutions. See discussion infra

at page 18.
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Even if the pass-through certificates are considered securities within the meaning of the Glass-Steagall Act, however, the Act's prohibitions are still not applicable to the Bank's program. Section 16 of the Act provides, in relevant part, that the "business of dealing in securities and stock [by a national bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the [bank] shall not underwrite any issue of securities or stock." This section explicitly restricts national banks' securities dealing and underwriting activities. As described in the Bank's Prospectus and Prospectus Supplement, the Bank serves as issuer of the Certificates and may also participate in their sale or distribution to the public. The first question, therefore, is whether the Bank's involvement in the distribution of these Certificates falls within the meaning of the terms "dealing" or "underwriting" in Section 16.

The term "underwriting", as used in the investment banking business, is commonly understood to refer to the process by which newly issued securities are purchased by another firm for distribution and sale to investors. See L. Loss, Fundamentals of Securities Regulation 81-90 (1983). Similarly, the term "dealing" also generally encompasses purchase and sale activity with respect to the securities of other issuers. An issuer that merely participates in the initial placement of its own securities with investors, and does not subsequently engage in the business of repurchasing those securities, does not thereby enter into the "business of underwriting" nor does it become involved in the "business of dealing." In this regard, we underscore the point that the activity in question is, in substance, a sale of the Bank's assets. n13 The Bank is not in this transaction purchasing and selling securities of other issuers but, rather, is participating in the placement of certificates representing interests in its own assets. n14 As this Office has recently stated, Section 16 is intended to control the types and amount of national bank purchase and sale activity with respect to securities issued by others, but this section does not affect a bank's activities with respect to its own securities. See Fed. Banking L. Rep. (CCH), supra P85,602. n15 Because we conclude that the Bank's activities are specifically authorized under the national banking laws, including 12 U.S.C. § 24 (Seventh), these activities are not prohibited by Section 16 of the Glass-Steagall Act, incorporated as an amendment thereto in 1933.

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n13 The Supreme Court's decision in Securities Industry Association v. Board of Governors of the Federal Reserve System, 468 U.S. 137 (1984) ("Becker"), does not mandate a contrary result. In Becker, the Court rejected the Federal Reserve Board's conclusion that commercial paper should not be treated as a "note" under Section 21 of the Glass-Steagall Act, stating that the Act does not allow for making distinctions based on the characteristics of particular notes. In addition because the Board had issued guidelines to govern the placement of third party commercial paper by state member banks, the Court concluded that the Board had converted one of the Act's flat prohibitions into a system of administrative regulation. Also, the Court was unable to find authority in the national banking laws for the business of "dealing" in commercial paper, as opposed to bank purchases of such paper which the Court described as the business of "discounting" notes. Finally, the Court suggested that the Board's analysis had caused it to ignore the bank's role in placing the commercial paper of other issuers, a practice which the Court felt raised the very hazards that Glass-Steagall was intended to prevent. The Court observed that a bank engaged in the distribution of third party commercial paper might improperly advise its clients to issue commercial paper so as to profit from the distribution process or in order to use the proceeds of the offering to retire a debt owed the bank. The Court was also concerned that such banks might use their credit facilities to shore up clients whose commercial paper they were distributing.

By contrast, the subject transaction raises none of these concerns. The Supreme Court specifically noted in Becker that the Glass-Steagall Act is not intended to affect the authority of commercial banks to conduct the business of banking. Id. at 158-59 n.11. Because the Bank's program in this case merely involves the sale of bank assets, which is part of the business of banking, the national banking laws, including Glass-Steagall, do not restrict the means by which this activity may be conducted. The OCC does not rely on the particular characteristics of the Bank's Certificates or establish a scheme of administrative regulation in order to assure the legality of the Bank's activity. Unlike in Becker, the Bank's activity cannot even arguably be characterized as "dealing" in or "underwriting" another issuer's securities but is an authorized banking practice. See discussion supra at pages 11-12. Further, because, among other things, the Bank is selling interests in its own assets rather than the securities of a third party issuer, the Bank's program does not present the inherent conflicts of interest which were the focus of the Court's concern in Becker. See discussion infra at pages 18-20.

n14 The fact that the Prospectus Supplement designates the Bank as "underwriter" of the Certificate series has no bearing on the Glass-Steagall analysis. Whether the Bank is underwriting within the meaning of the Glass-Steagall Act depends upon the transaction itself [e.g., there must be a public offering, See Securities Industry Association v. Board of Governors of the Federal Reserve System, 807 F.2d 1052, 1066 (D.C. Cir. 1986) ("SIA v. Board of Governors")], and upon the Bank's role in the transaction, as discussed herein. Here, the Prospectus Supplement has merely labeled the Bank as underwriter for purposes of indicating that it may place the Certificates directly with investors, but this does not change the Bank's role in the transaction. Cf. Becker, 468 U.S. at 154-60 (bank's role in transaction is significant part of Glass-Steagall analysis).

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n15 It is also instructive to note that the Bank's conduct in this transaction does not appear to bring it within the definitions of the terms "underwriter" or "dealer" contained in the Securities Act of 1933 ("Securities Act"). The Securities Act defines "underwriter" as "any person who has purchased from an issuer with a view to, or offers to sell for an issuer in connection with, the distribution of any security. . ." 15 U.S.C. § 77b(11). Similarly, the Securities Act defines "dealer" as one who "engages . . . in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person." 15 U.S.C. § 77b(12). Thus, as defined in the Securities Act, both of these terms denote activity with respect to the securities of another issuer. While the broader definitions of the federal securities laws are not controlling for purposes of the Glass-Steagall Act, these statutes were enacted during the same time period, and the Supreme Court has previously sought guidance from the securities laws in understanding the ordinary meaning of terms that also appear in Glass-Steagall. See Becker, 468 U.S. at 150-52. See also SIA v. Board of Governors, 807 F.2d at 1062-64. We do not believe, however, that activities not subject to the federal securities laws could ever be subject to Glass-Steagall.

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If the Bank's activities are permissible under Section 16, there is no need to conduct any inquiry under Section 21 of the Act. n16 That section prohibits any organization "engaged in the business of issuing, underwriting, selling, or distributing, . . . securities" from engaging at the same time in the business of receiving deposits. Even if separate consideration of Section 21 is warranted, however, the Bank's involvement in this transaction is permitted because the Bank is not engaged in any of the prohibited businesses. n17

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n16 In a recent case addressing the inteerplay of these two sections, the Court of Appeals for the District of Columbia Circuit explained that Section 21 must be addressed only if Section 16 is inapplicable. See SIA v. Board of Governors, 807 F.2d at 1057.

n17 Having determined that the Bank is not "underwriting" in violation of Section 16, no further analysis is necessary to conclude that the Bank is also not in violation of the underwriting prohibition contained in Section 21. See Becker, 468 U.S. at 149.

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In analyzing this section, it is important to recognize that it does not absolutely prohibit depository institutions from conducting the listed activities. Specifically, Section 21 provides that it does not prohibit national banks from "issuing securities" to the extent permitted under 12 U.S.C. § 24. Further, it is beyond dispute that Section 21 does not affect national banks' ability to raise funds from their operations through the issuance, distribution and sale of a variety of debt and equity securities. The authority for national banks to issue these securities is evident from several different provisions of the national banking laws, and the Comptroller's regulations thereunder. See, e.g., 12 U.S.C. § 51 (requirement of capital); 12 U.S.C. § 51c (defining "capital" as including common stock plus outstanding preferred stock); 12 U.S.C. § 51a (authorizing the issuance of preferred stock); 12 U.S.C. § 52 (prescribing form of stock certificates and indicating possibility of more than one class of stock); 12 C.F.R. § 3.100 (subordinated notes and debentures may be treated as part of capital if certain criteria are met).

In this context, the power to issue securities to raise funds for national bank operations necessarily encompasses the power to distribute and sell these securities to the investing public. In fact, national banks have for years sold their own debt and equity securities directly to investors through public offerings without there being any suggestion that this activity is barred by the Glass-Steagall Act. See 12 C.F.R. Part 16. Moreover, as you are aware, members of the SIA frequently assist in the marketing of mortgage-backed and other asset-backed certificates for national banks. If the "issuance" of these instruments is not legal, these SIA members could be exposed to liability under Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k (civil liability for false registration statement).

For similar reasons, in considering the subject transaction, we do not believe that Section 21 is intended to affect a bank's ability to raise funds for its operations through the issuance (and distribution and sale) of certificates representing interests in its own assets. Section 21 is primarily intended to prevent investment banks from receiving deposits. Recent court decisions have emphasized, however, that the Glass-Steagall Act is not intended to bar national banks, which obviously do receive deposits, from activity that is authorized under other provisions of the Act or the national banking laws. See, e.g., Becker, 468 U.S. at 158 n.11 (Glass-Steagall not intended to interfere with activities authorized as part of the "business of banking"); Board of Governors of Federal Reserve System v. Investment Company Institute, 450 U.S. 46, 63 (1981) ("Board of Governors") (Section 21 not intended to require abandonment of accepted banking practice consistent with Section 16); SIA v. Board of Governors, 807 F.2d at 1057 (Section 21 cannot be read to prohibit what Section 16 permits); IRA cases, supra (Glass-Steagall does not prohibit national banks from conducting bona fide fiduciary activity through operation of an IRA trust, notwithstanding recent entry of banks into this field). As we have seen, Section 16 places no limitations on the issuance of securities by national banks, and the national banking laws permit the use of the participation certificate form as a means of selling or transferring interests in bank assets. In view of this analysis, and the above discussion concerning the permissibility of various national bank securities issuances, distributions, and sales under Section 21, we think it clear that the Glass-Steagall Act does not prohibit national banks from raising funds through the issuance of certificates representing interests in their pooled assets. n18

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n18 The SIA's letter also suggests that the Bank's activity involves violations of Sections 20 and 32 of Glass-Steagall, 12 U.S.C. §§ 377 and 78. Section 20 prohibits affiliations between national banks and organizations "engaged principally in the issue, flotation, underwriting, public sale, or distribution . . . of securities." Section 32 prohibits national banks from sharing officers, directors or employees with organizations "primarily engaged" in these same activities. These sections of the Act would only be applicable if the trust created in the course of pooling the mortgage loans were viewed as an entity distinct from the Bank. In the past, since the trust is merely the vehicle used for packaging the bank's assets, this Office has considered the trust to be legally transparent and not a distinct entity for purposes of the Glass-Steagall analysis. Cf. Fed. Banking L. Rep. (CCH), supra P 85,421 (pool of FHA-insured mortgages assigned to trustee considered legally transparent for purposes of Section 16).

Even if we consider the trust to be a distinct entity, however, the Supreme Court has made it abundantly clear that a one-time initial issuance of securities, as in the issuance of a closed-end investment company's shares, is not sufficient to render a company "principally engaged" in the issuance of securities within the meaning of Section 20. Otherwise, "all corporations, including banks, would at some point be engaged principally in the issuance of securities." Board of Governors, 450 U.S. at 60-61 n.26. For the same reasons, it seems obvious that a one-time issuance could not result in an entity's being "primarily engaged" in the issuance of securities within the meaning of Section 32. Further, as this Office has recently stated, securities activities which are authorized for national banks under Section 16 are similarly permitted for their affiliates under Section 20. See January 29, 1987 letter of Richard V. Fitzgerald, Chief Counsel. See also Board of Governors, 450 U.S. at 61 n.26 (conclusion that Federal Reserve Board regulation is permitted under §§ 16 and 21 subsumes the argument that it violates § 20); Camp, 401 U.S. at 626 n.12 (limitations placed on activities of national banks are at least as great as limitations placed on activities of their affiliates). Based on the foregoing, and our conclusions supra regarding the permissibility of the Bank's activities under Sections 16 and 21, we are satisfied that the Bank's program does not involve any violation of Section 20 or Section 32.

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Further, in the case of national banks' issuance and sale of mortgage related pass-through certificates, this Office has in the past also relied upon explicit language contained in Section 21, "that nothing in this paragraph shall be construed as affecting in any way such right as any bank . . . may otherwise possess to sell, without recourse or agreement to repurchase, obligations evidencing loans on real estate." This language is understood to reflect the intent of Congress not to disturb the secondary market for real estate loans made by financial institutions. See June 18, 1986 letter from Robert L. Clarke, supra, and letters cited therein.

Finally, a review of the Bank's program in light of the purposes of the Glass-Steagall Act, as identified by the Supreme Court in Camp and Becker, supra, and in other court cases, reinforces our conclusion that the Bank's activities are fully permissible under applicable law. At the outset, we note that the most obvious of the Glass-Steagall hazards, the danger of commercial bank investment in speculative stock or securities, is wholly absent from the Bank's program. See Camp, 401 U.S. at 630. At no time will the Bank's resources be committed to any securities investment whatsoever, since the program involves only the sale of bank assets.

The Bank's program also does not present the significant "subtle hazards" associated with prohibited bank securities activities under the Supreme Court's previous Glass-Steagall determinations. These "subtle hazards" are thought to arise when a commercial bank's promotional interest in the success of particular securities investments or its securities affiliates might interfere with the bank's ability to act as an impartial source of credit or to render disinterested investment advice. See Camp, 401 U.S. at 630-34; Becker, 468 U.S. at 145-47.

Under the Bank's program, which does not involve the marketing of bank customers' securities, most of the conflicts of interest identified by the Supreme Court in Becker, supra, are simply not at issue. The Bank does not have a promotional interest in the success of any customer's securities, thus it will not be tempted to make unsound loans to customers in order to influence the success of their securities offerings. Similarly, there is no possibility that the Bank might improperly advise its customers on how and when to issue securities in order to profit from the distribution process or to use the proceeds in obtaining repayment on outstanding loans. n19

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n19 The Bank's program might affect its ability to serve as disinterested financial advisor to customers who are potential purchasers of the Certificates. This hazard, however, is not unique to the securities business. Indeed, it is present in any sale to customers of bank services or products. In fact, this very hazard was found to be present in SIA v. Board of Governors, supra, where the Court observed that "'subtle hazards' counsel prohibition of a banking practice only when the practice gave rise to each and every one of the hazards." 807 F.2d at 1069.

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We also do not believe that the possibility of the Bank's providing limited credit support for future certificate series raises any Glass-Steagall hazard. In actuality, if the Bank were to issue its own letter of credit, this would only mean that the Bank would retain a small portion of the credit risk it had already incurred in the normal course of originating the underlying mortgage loans. Considering that in the absence of the Bank's sale of these assets it would retain 100% of the associated credit risk, it is difficult to conceive how a decision to provide credit support for no more than 10% of the initial aggregate principal balance of a pool comprised of these same assets could be the product of "unsound" lending practices.

Nor do we think it likely that the Bank's program will have any effect on the soundness of its mortgage lending practices. Traditionally, banks have sold their mortgage assets through loan participations, and the use of the pass-through certificate to accomplish such sales raises no additional safety and soundness issues. The Bank's use of the pass-through certificate to sell whole mortgage loans merely allows it to utilize the most efficient means of transferring these assets. We think it extremely unlikely that a bank would engage in unsafe mortgage lending practices simply because of the possibility that the resulting mortgage loans might thereafter be placed in a pool and sold in certificate form. In this regard, at the time of origination, it will generally not be possible for the Bank to know whether a particular loan will be suitable for subsequent inclusion in a public offering. In addition, the Bank would have difficulty marketing the Certificates if the underlying mortgages were themselves unsound investments because the federal securities laws require full disclosure of all material facts concerning the Certificates and the offering. In short, the Bank does not stand to profit by making unsound loans with the intent of remarketing them to uniformed purchasers. See SIA v. Board of Governors, 807 F.2d at 1068 (economic realities and impact of full disclosure under federal securities laws are relevant to hazards analysis).

We also do not believe that the Bank's involvement in this program is likely to result in its making unsound loans to deposit customers in order to finance their purchase of the pass-through certificates. Because of the servicing fee, the pass-through rate will be lower than the interest rates on the underlying mortgage loans. From the customer's point of view, it would be irrational to obtain a bank loan at the higher commercial rate so as to invest in the Bank's Certificates at the lower pass-through rate. Similarly, since the Bank's objective is to sell the mortgage loans, it would hardly make economic sense for it to replace these assets with unsound loans acquired in the process. Finally, there is no risk that the Bank's reputation might suffer as a result of its being identified with the Certificates because the Prospectus makes full disclosure of all material risks associated with the offering. Accordingly, we conclude that the Bank's program overall does not raise the conflicts of interest and other hazards that are characteristic of the securities activities prohibited to national banks under the Glass-Steagall Act.

In conclusion, we are satisfied that the Bank's program, as described in the Prospectus and Prospectus Supplement dated January 23, 1987, is squarely based on long-standing precedent that is fully supported by applicable law and subsequent court decisions interpreting these laws. In pooling its mortgage loans and selling interests therein, the Bank is merely engaging in a permitted sale of its mortgage assets. We cannot conclude that the Glass-Steagall Act is intended to preclude banks from conducting this activity. We trust that this letter has been responsive to your request.

Sincerely,

Comptroller of the Currency
Washington, DC 20219

Release Date: March 1988
**Interpretive Letter No. 418**

*1988 OCC Ltr. LEXIS 16; Fed. Banking L. Rep. (CCH) P85,642*

February 17, 1988

[*1]

Re: BancBoston Mortgage Securities, Inc.

Douglas A. Bacon, Esq.
Senior Counsel
The First National Bank of Boston
Boston, Massachusetts 02106

Dear Mr. Bacon:

This letter responds to the notification by The First National Bank of Boston ("Bank") of its intent to establish a new operating subsidiary, BancBoston Mortgage Securities, Inc. ("Mortgage Securities"). Mortgage Securities will be a wholly owned subsidiary of an existing wholly owned operating subsidiary of the Bank, BancBoston Mortgage Companies, Inc. ("Mortgage Companies"). Mortgage Securities is being organized to facilitate the securitization of mortgage assets held by Mortgage Companies and its other mortgage subsidiaries in the course of their mortgage banking business. The Office previously has found similar proposals permissible for national banks. Accordingly, the Office approves the Bank's establishment of Mortgage Securities.

The Bank's Proposal

Our understanding of the Bank's proposal is based upon the Bank's operating subsidiary notification letter, dated March 9, 1987, the Bank's supplemental letter, dated June 18, 1987, and your telephone conversations with Richard H. Cleva, a senior [*2] attorney in the Legal Advisory Services Division of this Office.

Mortgage Companies is an existing subsidiary of the Bank which engages in the mortgage banking business both directly and through three wholly owned second-tier subsidiaries. Mortgage Securities will be a wholly owned subsidiary of Mortgage Companies and is being organized to facilitate the sale, in securitized forms, of mortgage assets held by Mortgage Companies, its three other subsidiaries, the Bank, or affiliates of the Bank. Mortgage Securities will conduct its business from an office located in Jacksonville, Florida, which is neither the main office nor a branch of the Bank.

Mortgage Securities is being organized to issue mortgage-related instruments based upon mortgage assets held by its affiliates. In so doing, Mortgage Securities will engage in the following activities. First, it will acquire, own, hold, sell, transfer, assign, pledge, finance, refinance, and/or otherwise deal in (a) fully modified pass-through certificates ("GNMA Certificates") guaranteed as to the timely payment of principal and interest by the Government National Mortgage Association ("GNMA"), (b) mortgage pass-through certificates [*3] ("FNMA Certificates") guaranteed as to the timely payment of principal and interest by the Federal National Mortgage Association ("FNMA"), (c) mortgage participation certificates ("FHLMC Certificates", and, together with the GNMA Certificates and the FNMA Certificates, "Agency Certificates") guaranteed as to the ultimate payment of principal and the timely payment of interest by the Federal Home Loan Mortgage Corporation ("FHLMC"), and (d) conventional residential mortgage loans.

Second, it will authorize, issue, and deliver bonds or other evidences of indebtedness (in single or multi-class form) either directly or through grantor trusts established by Mortgage Securities, which bonds or other evidences of indebtedness would be collateralized by a pool of Agency Certificates and/or conventional residential mortgage loans (each such bond or other evidence of indebtedness a "Collateralized Mortgage Obligation" or "CMO"). Third, it will authorize, issue, and deliver certificates or other evidences of an ownership interest (in single or multi-class form) in a pool of Agency Certificates and/or conventional residential mortgage loans (each such certificate or other evidence of an ownership [*4] interest a "Pass-Through Certificate"). Fourth, it will authorize, issue, and deliver any other similar instruments, bonds, certificates, evidences of indebtedness or ownership, or securities as may by law be permitted. Fifth, it will engage in other activities incidental to accomplishing the foregoing.

The CMOs or Pass-Throughs issued by Mortgage Securities may be backed by either Agency Certificates or mortgage loans. The Agency Certificates are intended primarily to be Agency Certificates issued by GNMA, FNMA, or FHLMC in exchange for mortgage loans originated by Mortgage Companies or other affiliates of Mortgage Securities. However, it is also intended that Mortgage Securities will supplement such Agency Certificates with other Agency Certificates purchased in the open market.

Of the mortgage loans used to back CMOs or Pass-Throughs issued by Mortgage Securities, approximately fifty percent of the mortgages in Mortgage Securities portfolio will have been originated by parties unrelated to Mortgage Securities, i.e., correspondent institutions, and approximately fifty percent will have been originated by Mortgage Companies, its subsidiaries, the Bank, and its other [*5] subsidiaries and affiliates. Mortgage Companies and its mortgage banking subsidiaries regularly sell and purchase mortgages from other institutions in the secondary mortgage market as a routine part of their mortgage banking business. They purchase only mortgages which comply with Mortgage Companies' own underwriting standards used on direct originations. Those underwriting standards are FNMA/FHLMC standards for conventional loans and FHA/VA standards for FHA and VA loans, as applicable. Any mortgages purchased by Mortgage Companies or its subsidiaries are reviewed to ensure that they meet or exceed these standards. Whether originated by Mortgage Companies and its affiliates or purchased, it is expected that substantially all of the conventional residential mortgage loans acquired by Mortgage Securities and used to collateralize CMOs or underlie Pass-Through Certificates issued by Mortgage Securities will be loans serviced by Mortgage Companies, its subsidiaries, or other affiliates of the Bank.

Transactions would be structured as follows: Mortgage Securities would purchase the mortgage loans or Agency Certificates from the affiliates referred to above and would then issue [*6] and sell the CMOs or Pass-Through Certificates to the underwriter, securing them with a pledge of the mortgages or Agency Certificates to a trustee. The proceeds of each issuance of CMOs or Pass-Through Certificates will be used to purchase the collateral necessary to secure the CMOs or to purchase the mortgage interests underlying the Pass-Through Certificates. It is presently contemplated that the CMOs or Pass-Through Certificates proposed to be issued by Mortgage Securities would be issued in a number of series under a pooling agreement, indenture, or similar document between Mortgage Securities or a trust established by Mortgage Securities and an unaffiliated trustee, and would bear interest at rates to be determined for each series. Mortgage Securities may elect to treat certain of the CMOs or Pass-Through Certificates issued as regular or residual interests in a real estate mortgage investment conduit ("REMIC") under the Internal Revenue Code of 1986.

The CMOs or Pass-Through Certificates issued by Mortgage Securities would be registered with the Securities and Exchange Commission under the Securities Act of 1933. The holders of any CMOs or Pass-Through Certificates issued [*7] by Mortgage Securities would not have any recourse against the Bank, Mortgage Companies, its mortgage subsidiaries, or any other affiliate of the Bank (except against Mortgage Securities in the case of a CMO issued by Mortgage Securities directly). The only recourse of the holders of any CMOs (other than those issued by Mortgage Securities directly) or Pass-Through Certificates would be to exercise their rights with respect to such collateral or such underlying mortgage interests, as the case may be, and to enforce the guaranty of any third party, such as GNMA. This fact would be brought prominently to the attention of prospective investors, who would also be specifically informed that the CMOs or Pass-Through Certificates do not represent bank deposits and are not insured by the Federal Deposit Insurance Corporation.

The Bank has engaged the services of an independent, unrelated investment banking firm to act as underwriter for the initial offering by Mortgage Securities. The Bank, Mortgage Securities, and other affiliates do not intend to engage in activities which would cause them to be treated as underwriters of Mortgage Securities' issuances under the federal securities [*8] laws.

In addition, the Bank will not finance any purchaser's acquisition of the CMOs or Pass-Through Certificates, will not purchase any of the CMOs or Pass-Through Certificates for any trust or agency account as to which it has investment discretion or for the Bank's pension accounts, will not promote the CMOs or Pass-Through Certificates, and will not lend money to Mortgage Securities.

Discussion

These activities -- i.e., participation in the mortgage banking business including the buying and selling of mortgage assets (and lending or borrowing collateralized by mortgage assets) in both direct and securitized formats -- are permissible activities for national banks and their subsidiaries and have been previously approved by this Office. Accordingly, we believe the proposed activities of Mortgage Securities are permissible and approve the Bank's proposal.

The origination and making of real estate loans on the part of the bank; the purchase and sale of real estate loans and participations therein; and the originating, warehousing, and servicing of loans on behalf of other investors are centrally traditional banking activities. See, e.g., *12 U.S.C. §§ 24*(7) [*9] & 371(a); 12 C.F.R. § 34.1; 12 C.F.R. § 7.7379; *First National Bank of Hartford v. City of Hartford, 273 U.S. 548, 559-60 (1927).*

This mortgage banking business includes making loans and holding them in portfolio, making loans and selling them on to other lenders, purchasing loans from other loan-originators and holding them, purchasing loans and selling them on, and servicing loans. The mix of activities in any given bank's mortgage banking business at any particular time depends on such factors as local lending opportunities, secondary market lending opportunities, local funding opportunities, secondary market funding opportunities, and so on.

The Office also believes that the activity of selling mortgages into the secondary market, or alternatively raising lendable funds by borrowing in the market secured by mortgages, may be accomplished by the use of the securitized formats which the market has developed in the last decades as well as by direct methods. The securitized formats are tools used to effect the selling, purchasing, borrowing, and lending functions of the secondary market. They were developed so that these market functions could be accomplished more efficiently; [*10] but they are mere tools, another means of performing the same functions.

In keeping with this view, the Office, at least as far back as 1977, has approved of national banks' use of pass-through certificates, collateralized mortgage obligations, or similar instruments as vehicles for selling, or borrowing against, mortgage assets. See, e.g., Letter of Robert L. Clarke, Comptroller of the Currency (June 18, 1986) (unpublished) (surveying prior letters and elaborating Office's legal analysis); OCC No-action Letter No. 86-9 (May 22, 1986), reprinted in *Fed. Banking L. Rep (CCH) P84,015* (bank issuance and sale of CMOs based on pools of agency mortgage certificates and/or mortgage loans); OCC Interpretive Letter No. 257 (April 12, 1983), reprinted in *Fed. Banking L. Rep. (CCH) P85,421* (bank selling and dealing in pass-through certificates where pool of loans consists of obligations expressly eligible under section 24(7)); OCC Interpretive Letter No. 92 (April 20, 1979), reprinted in *Fed. Banking L. Rep. (CCH) P85,167* (pool of conventional mortgage loans, bank sale through issuance of pass-through certificates in two classes); OCC Interpretive Letter No. 41 (May 18, 1978), [*11] reprinted in *Fed. Banking L. Rep. (CCH) P85,116* (pool of conventional mortgage loans, bank sale through issuance of pass-through certificates); OCC Interpretive Letter No. 25 (February 14, 1978), reprinted in *Fed. Banking L. Rep. (CCH) P85,100* (pool of conventional mortgages, bank sale through issuance of pass-through certificates, and bank employees marketing the certificates in private placements); Letter of Robert Bloom, Acting Comptroller of the Currency (March 29, 1977), reprinted in *Fed. Banking L. Rep. (CCH) P97,093* (pool of conventional mortgage loans, bank sale through issuance of pass-through certificates).

In addition, on two more recent occasions, the Office has reiterated its views on national banks' use of pass-through certificates and CMO vehicles. In one letter, in addition to the Office's traditional analysis of the bank's power to use these vehicles, various operational legal, accounting, and reporting questions in the use of CMOs were discussed. See OCC Interpretive Letter No. 378 (March 24, 1987), reprinted in *Fed. Banking L. Rep. (CCH) P85,602.* In another letter, the Office considered the additional factual element that the bank participated [*12] in the public selling efforts for its pass-through certificates, in addition to using an independent investment bank for sales efforts, and concluded this activity was also permissible for banks. See OCC Interpretive Letter No. 388 (June 16, 1987), reprinted in *Fed. Banking L. Rep. (CCH) P85,612,* suit pending, Securities Industry Association v. *Clarke, No. 87-4504* (S.D.N.Y. filed June 25, 1987).

As can be seen from the foregoing list of prior letters, the activities involved in the Bank's proposal are within the scope of these contemplated in the Office's various prior authorizations from 1977 forward. Indeed, since the Bank intends to use an independent investment bank and will not itself participate in the selling efforts, the Bank's proposal is within the Office's pre-1987 letters and does not involve a factual setting similar to Letter No. 388 of June 16, 1987. Inasmuch as the Office has previously determined these activities to be permissible for national banks, we find the Bank's proposed activities in Mortgage Securities similarly permissible.

Mortgage Securities will conduct its activities from an office which is neither the head office nor a branch [*13] of the Bank. However, in our opinion the proposed activities of Mortgage Securities do not include the types of business for which a branch license is required under *12 U.S.C. § 36*(f), because its activities do not involve the three types of banking business enumerated in section 36(f) -- i.e., making loans, receiving deposits, or paying checks. See *Clarke v. Securities Industry Association, 479 U.S. , 93 L. Ed. 2d 757, 772-75 (1987).* Thus, Mortgage Securities' activities may be performed at locations other than branches, and the Bank's proposal is accordingly consistent with *12 U.S.C. § 36.*

Finally, the Bank's proposal is not affected by the recently enacted Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552. In section 201(b) of the Act, Congress passed a temporary moratorium on approvals of certain securities activities of banking organizations. Under section 201(b)(2)(B), a federal banking agency may not authorize a bank to engage "in any securities activity not legally authorized in writing prior to March 5, 1987." Assuming without deciding that the Bank's proposal would involve a "securities activity" within the meaning of the [*14] Act, it is nevertheless not covered by the moratorium since the activities in the Bank's proposal are like those authorized in the Office's prior letters from 1977 onward, such as those discussed earlier. Moreover, the Act also does not affect "activities which had been lawfully engaged in prior to March 5, 1987." Because banks have previously engaged in the activities involved in the Bank's proposal (as shown, for example, in the transactions which were the subjects of the Office's prior letters), the Bank's proposal is not affected by the moratorium also under this provision.

Conclusion

As set forth above, the proposed activities of Mortgage Securities are within the scope of activities previously determined to be permissible for national banks and their operating subsidiaries. Thus, in light of the above precedents and based upon our review of your description of Mortgage Securities' activities and your legal analysis, we believe the proposed activities are permissible. Accordingly, the Bank may proceed with its proposal under 12 C.F.R. § 5.34.

Very truly yours,

J. Michael Shepherd
Senior Deputy Comptroller for Corporate and Economic Programs

Comptroller of the Currency
Administrator of National Banks

# Asset Securitization

Comptroller's Handbook

November 1997

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## Background

Asset securitization is helping to shape the future of traditional commercial banking. By using the securities markets to fund portions of the loan portfolio, banks can allocate capital more efficiently, access diverse and cost-effective funding sources, and better manage business risks.

But securitization markets offer challenges as well as opportunity. Indeed, the successes of nonbank securitizers are forcing banks to adopt some of their practices. Competition from commercial paper underwriters and captive finance companies has taken a toll on banks' market share and profitability in the prime credit and consumer loan businesses. And the growing competition within the banking industry from specialized firms that rely on securitization puts pressure on more traditional banks to use securitization to streamline as much of their credit and originations business as possible. Because securitization may have such a fundamental impact on banks and the financial services industry, bankers and examiners should have a clear understanding of its benefits and inherent risks.

This booklet begins with an overview of the securitization markets, followed by a discussion of the mechanics of securitization. The discussion evolves to the risks of securitization and how, at each stage of the process, banks are able to manage those risks.

A central theme of this booklet is the bank's use of asset securitization as a means of funding, managing the balance sheet, and generating fee income. The discussion of risk focuses on banks' roles as financial intermediaries, that is, as loan originators and servicers rather than as investors in asset-backed securities. Although purchasing asset-backed securities as investments clearly helps to diversify assets and manage credit quality, these benefits are discussed in other OCC publications, such as the "Investment Securities" section of the *Comptroller's Handbook*.

## Definition

Asset securitization is the structured process whereby interests in loans and other receivables are packaged, underwritten, and sold in the form of "asset-backed" securities. From the perspective of credit originators, this market enables them to transfer some of the risks of ownership to parties more willing or able to manage them. By doing so, originators can access the funding markets at debt ratings higher than their overall corporate ratings, which generally gives them access to broader funding sources at more favorable rates. By removing the assets and supporting debt from their balance sheets, they are able to save some of the costs of on-balance-sheet financing and manage potential asset-liability mismatches and credit concentrations.

## Brief History

Asset securitization began with the structured financing of mortgage pools in the 1970s. For decades before that, banks were essentially portfolio lenders; they held loans until they matured or were paid off. These loans were funded principally by deposits, and sometimes by debt, which was a direct obligation of the bank (rather than a claim on specific assets).

But after World War II, depository institutions simply could not keep pace with the rising demand for housing credit. Banks, as well as other financial intermediaries sensing a market opportunity, sought ways of increasing the sources of mortgage funding. To attract investors, investment bankers eventually developed an investment vehicle that isolated defined mortgage pools, segmented the credit risk, and structured the cash flows from the underlying loans. Although it took several years to develop efficient mortgage securitization structures, loan originators quickly realized the process was readily transferable to other types of loans as well.

Since the mid 1980s, better technology and more sophisticated investors have combined to make asset securitization one of the fastest growing activities in the capital markets. The growth rate of nearly every type of securitized asset has been remarkable, as have been the increase in the types of companies using securitization and the expansion of the investor base. The business of a credit intermediary has so changed that few banks, thrifts, or finance companies can afford to view themselves exclusively as portfolio lenders.

## Market Evolution

The market for mortgage-backed securities was boosted by the government agencies that stood behind these securities. To facilitate the securitization of nonmortgage assets, businesses substituted private credit enhancements. First, they overcollateralized pools of assets; shortly thereafter, they improved third-party and structural enhancements. In 1985, securitization techniques that had been developed in the mortgage market were applied for the first time to a class of nonmortgage assets — automobile loans. A pool of assets second only to mortgages, auto loans were a good match for structured finance; their maturities, considerably shorter than those of mortgages, made the timing of cash flows more predictable, and their long statistical histories of performance gave investors confidence.

The first significant bank credit card sale came to market in 1986 with a private placement of $50 million of bank card outstandings. This transaction demonstrated to investors that, if the yields were high enough, loan pools could support asset sales with higher expected losses and administrative costs than was true within the mortgage market. Sales of this type — with no contractual obligation by the seller to provide recourse — allowed banks to receive sales treatment for accounting and regulatory purposes (easing balance sheet and capital constraints), while at the same time allowing them to retain origination and servicing fees. After the success of this initial transaction, investors grew to accept credit card receivables as collateral, and banks developed structures to normalize the cash flows.

The next growth phase of securitization will likely involve nonconsumer assets. Most retail lending is readily “securitizable” because cash flows are predictable. Today, formula-driven credit scoring and credit monitoring techniques are widely used for such loans, and most retail programs produce fairly homogeneous loan portfolios. Commercial financing presents a greater challenge. Because a portfolio of commercial loans is typically less homogeneous than a retail portfolio, someone seeking to invest in them must often know much more about each individual credit, and the simpler tools for measuring and managing portfolio risk are less effective. Nonetheless, investment bankers and asset originators have proven extremely innovative at structuring cash flows and credit enhancements. Evidence of this can be seen in the market for securitized commercial real estate mortgages. Commercial real estate is one of the fastest-growing types of nonconsumer assets in the securitization markets, which fund approximately 10 percent of commercial mortgage debt.

## Benefits of Asset Securitization

The evolution of securitization is not surprising given the benefits that it offers to each of the major parties in the transaction.

### For Originators

Securitization improves returns on capital by converting an on-balance-sheet lending business into an off-balance-sheet fee income stream that is less capital intensive. Depending on the type of structure used, securitization may also lower borrowing costs, release additional capital for expansion or reinvestment purposes, and improve asset/liability and credit risk management.

### For Investors

Securitized assets offer a combination of attractive yields (compared with other instruments of similar quality), increasing secondary market liquidity, and generally more protection by way of collateral overages and/or guarantees by entities with high and stable credit ratings. They also offer a measure of flexibility because their payment streams can be structured to meet investors' particular requirements. Most important, structural credit enhancements and diversified asset pools free investors of the need to obtain a detailed understanding of the underlying loans. This has been the single largest factor in the growth of the structured finance market.

### For Borrowers

Borrowers benefit from the increasing availability of credit on terms that lenders may not have provided had they kept the loans on their balance sheets. For example, because a market exists for mortgage-backed securities, lenders can now extend fixed rate debt, which many consumers prefer over variable rate debt, without overexposing themselves to interest rate risk. Credit card lenders can originate very large loan pools for a diverse customer base at lower rates than if they had to fund the loans on their balance sheet. Nationwide competition among credit originators, coupled with strong investor appetite for the securities, has significantly expanded both the availability of credit and the pool of cardholders over the past decade.

Before evaluating how a bank manages the risks of securitization, an examiner should have a fundamental understanding of asset-backed securities and how they are structured. This section characterizes asset-backed securities, briefly discusses the roles of the major parties, and describes the mechanics of their cash flow, or how funds are distributed.

## Basic Structures of Asset-Backed Securities

A security's structure is often dictated by the kind of collateral supporting it. Installment loans dictate a quite different structure from revolving lines of credit. Installment loans, such as those made for the purchase of automobiles, trucks, recreational vehicles, and boats, have defined amortization schedules and fixed final maturity dates. Revolving loans, such as those extended to credit card holders and some home equity borrowers, have no specific amortization schedule or final maturity date. Revolving loans can be extended and repaid repeatedly over time, more or less at the discretion of the borrower.

### Installment Contract Asset-Backed Securities

Typical installment contract asset-backed securities, which bear a close structural resemblance to mortgage pass-through securities, provide investors with an undivided interest in a specific pool of assets owned by a trust. The trust is established by pooling installment loan contracts on automobiles, boats, or other assets purchased from a loan originator, often a bank.

The repayment terms for most installment contract asset-backed securities call for investors to receive a pro rata portion of all of the interest and principal received by the trust each month. Investors receive monthly interest on the outstanding balance of their certificates, including a full month's interest on any prepayments. The amount of principal included in each payment depends on the amortization and prepayment rate of the underlying collateral. Faster prepayments shorten the average life of the issue.

### Revolving Asset Transactions

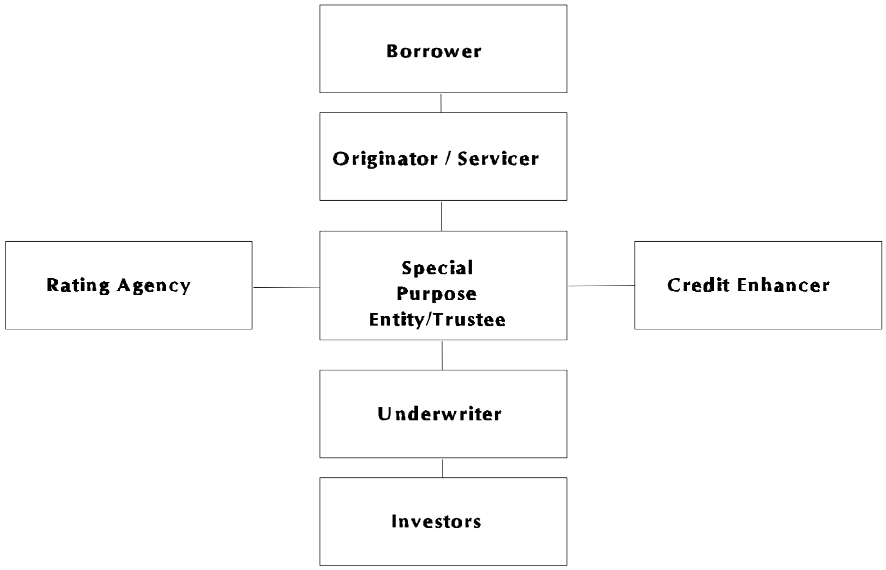
The typically short lives of receivables associated with revolving loan products (credit cards, home equity lines, etc.) require issuers to modify the structures used to securitize the assets. For example, a static portfolio of credit card receivables typically has a life of between five months and ten months. Because such a life is far too short for efficient security issuance, securities backed by revolving loans are structured in a manner to facilitate management of the cash flows. Rather than distributing principal and interest to investors as received, the securities distribute cash flow in stages — a revolving phase followed by an amortization phase. During the revolving period, only interest is paid and principal payments are reinvested in additional receivables as, for example, customers use their credit cards or take additional draws on their home equity lines. At the end of the revolving period an amortization phase begins, and principal payments are made to investors along with interest payments. Because the principal balances are repaid over a short time, the life of the security is largely determined by the length of the revolving period.

## Parties to the Transaction

The securitization process redistributes risk by breaking up the traditional role of a bank into a number of specialized roles: originator, servicer, credit enhancer, underwriter, trustee, and investor. Banks may be involved in several of the roles and often specialize in a particular role or roles to take advantage of expertise or economies of scale. The types and levels of risk to which a particular bank is exposed will depend on the organization's role in the securitization process.

With sufficient controls and the necessary infrastructure in place, securitization offers several advantages over the traditional bank lending model. These benefits, which may increase the soundness and efficiency of the credit extension process, can include a more efficient origination process, better risk diversification, and improved liquidity. A look at the roles played by the primary participants in the securitization process will help to illustrate the benefits.

**Exhibit 1: Parties Involved in Structuring Asset-Backed Securities**




*Borrower*. The borrower is responsible for payment on the underlying loans and therefore the ultimate performance of the asset-backed security. Because borrowers often do not realize that their loans have been sold, the originating bank is often able to maintain the customer relationship.

From a credit risk perspective, securitization has made popular the practice of grouping borrowers by letter or categories. At the top of the rating scale, 'A'-quality borrowers have relatively pristine credit histories. At the bottom, 'D'-quality borrowers usually have severely blemished credit histories. The categories are by no means rigid; in fact, credit evaluation problems exist because one originator's 'A' borrower may be another's 'A-' or 'B' borrower. Nevertheless, the terms 'A' paper and 'B/C' paper are becoming more and more popular.

Exhibit 2 is an example of generic borrower descriptions used by Duff and Phelps Credit Rating Corporation in rating mortgage borrowers. The borrowers' characteristics in the exhibit are generalizations of each category's standards and fluctuate over time; however, the table does provide an illustration of general standards in use today. For example, an 'A' quality

**Exhibit 2: Borrower Credit Quality Categories**

| Generic Borrower Credit Quality Description | Mortgage Credit | Other Credit | Recency of Bankruptcy | Debt to Income Ratio | Loan-to-Value Guidelines |
|---|---|---|---|---|---|
| A: Standard agency quality | 1 x 30 last 12 months | No derogatories | 5 yrs. | 36% | 97% |
| A-: Very minor credit problems | 1 x 30 last 12 months<br>2 x 30 last 24 months | Minor derogatories explained | 5 yrs. | 42% | 90% |
| B: Minor to moderate credit problems | 4 x 30 last 12 months<br>1 x 60 last 24 months | Some prior defaults | 3 yrs. | 50% | 75% |
| C: Moderate to serious credit problems | 6 x 30 last 12 months<br>1 x 60 & 1 x 90 last 12 months | Significant credit problems | 18 months | 55% | 70% |
| D: Demonstrated unwillingness or inability to pay | 30-60 constant delinquent, 2 x 90 last 12 months | Severe credit problems | 12 months | 60% | 65% |

*(Source: Duff & Phelps)*

borrower will typically have an extensive credit history with few if any delinquencies, and a fairly strong capacity to service debt. In contrast, a 'C' quality borrower has a poor or limited credit history, numerous instances of delinquency, and may even have had a fairly recent bankruptcy. Segmenting borrowers by grade allows outside parties such as rating agencies to compare performance of a specific company or underwriter more readily with that of its peer group.

*Originator*. Originators create and often service the assets that are sold or used as collateral for asset-backed securities. Originators include captive finance companies of the major auto makers, other finance companies, commercial banks, thrift institutions, computer companies, airlines, manufacturers, insurance companies, and securities firms. The auto finance companies dominate the securitization market for automobile loans. Thrifts securitize primarily residential mortgages through pass-throughs, pay-throughs, or mortgage-backed bonds. Commercial banks regularly originate and securitize auto loans, credit card receivables, trade receivables, mortgage loans, and more recently small business loans. Computer companies, airlines, and other commercial companies often use securitization to finance receivables generated from sales of their primary products in the normal course of business.

*Servicer.* The originator/lender of a pool of securitized assets usually continues to service the securitized portfolio. (The only assets with an active secondary market for servicing contracts are mortgages.) Servicing includes customer service and payment processing for the borrowers in the securitized pool and collection actions in accordance with the pooling and servicing agreement. Servicing can also include default management and collateral liquidation. The servicer is typically compensated with a fixed normal servicing fee.

Servicing a securitized portfolio also includes providing administrative support for the benefit of the trustee (who is duty-bound to protect the interests of the investors). For example, a servicer prepares monthly informational reports, remits collections of payments to the trust, and provides the trustee with monthly instructions for the disposition of the trust's assets. Servicing reports are usually prepared monthly, with specific format requirements for each performance and administrative report. Reports are distributed to the investors, the trustee, the rating agencies, and the credit enhancer.

*Trustee.* The trustee is a third party retained for a fee to administer the trust that holds the underlying assets supporting an asset-backed security. Acting in a fiduciary capacity, the trustee is primarily concerned with preserving the rights of the investor. The responsibilities of the trustee will vary from issue to issue and are delineated in a separate trust agreement. Generally, the trustee oversees the disbursement of cash flows as prescribed by the indenture or pooling and servicing agreement, and monitors compliance with appropriate covenants by other parties to the agreement.

If problems develop in the transaction, the trustee focuses particular attention on the obligations and performance of all parties associated with the security, particularly the servicer and the credit enhancer. Throughout the life of the transaction the trustee receives periodic financial information from the originator/servicer delineating amounts collected, amounts charged off, collateral values, etc. The trustee is responsible for reviewing this information to ensure that the underlying assets produce adequate cash flow to service the securities. The trustee also is responsible for declaring an event of default or an amortization event, as well as replacing the servicer if it fails to perform in accordance with the required terms.

*Credit Enhancer*. Credit enhancement is a method of protecting investors in the event that cash flows from the underlying assets are insufficient to pay the interest and principal due for the security in a timely manner. Credit enhancement is used to improve the credit rating, and therefore the pricing and marketability of the security.

As a general rule, third-party credit enhancers must have a credit rating at least as high as the rating sought for the security. Third-party credit support is often provided through a letter of credit or surety bond from a highly rated bank or insurance company. Because there are currently few available highly rated third-party credit enhancers, internal enhancements such as the senior/subordinated structure have become popular for many asset-backed deals. In this latter structure, the assets themselves and cash collateral accounts provide the credit support. These cash collateral accounts and separate, junior classes of securities protect the senior classes by absorbing defaults before the senior position's cash flows are interrupted.

*Rating Agencies.* The rating agencies perform a critical role in structured finance — evaluating the credit quality of the transactions. Such agencies are considered credible because they possess the expertise to evaluate various underlying asset types, and because they do not have a financial interest in a security's cost or yield. Ratings are important because investors generally accept ratings by the major public rating agencies in lieu of conducting a due diligence investigation of the underlying assets and the servicer.

Most nonmortgage asset-backed securities are rated. The large public issues are rated because the investment policies of many corporate investors require ratings. Private placements are typically rated because insurance companies are a significant investor group, and they use ratings to assess capital reserves against their investments. Many regulated investors, such as life insurance companies, pension funds, and to some extent commercial banks can purchase only limited amounts of securities rated below investment grade.

The rating agencies review four major areas:

- Quality of the assets being sold,
- Abilities and strength of the originator/servicer of the assets,

- Soundness of the transaction's overall structure, and
- Quality of the credit support.

From this review, the agencies assess the likelihood that the security will pay interest and principal according to the terms of the trust agreement. The rating agencies focus solely on the credit risk of an asset-backed security. They do not express an opinion on market value risks arising from interest rate fluctuations or prepayments, or on the suitability of an investment for a particular investor.

*Underwriter.* The asset-backed securities underwriter is responsible for advising the seller on how to structure the security, and for pricing and marketing it to investors. Underwriters are often selected because of their relationships with institutional investors and for their advice on the terms and pricing required by the market. They are also generally familiar with the legal and structural requirements of regulated institutional investors.

*Investors*. The largest purchasers of securitized assets are typically pension funds, insurance companies, fund managers, and, to a lesser degree, commercial banks. The most compelling reason for investing in asset-backed securities has been their high rate of return relative to other assets of comparable credit risk. The OCC's investment securities regulations at 12 CFR 1 allow national banks to invest up to 25 percent of their capital in "Type V" securities. By definition, a Type V security:

- Is marketable,
- Is rated investment grade,
- Is fully secured by interests in a pool of loans to numerous obligors and in which a national bank could invest directly, and
- Is not rated as a mortgage-related or Type IV security.

## Structuring the Transaction

The primary difference between whole loan sales or participations and securitized credit pools is the structuring process. Before most loan pools can be converted into securities, they must be structured to modify the nature of the risks and returns to the final investors. Structuring includes the isolation and distribution of credit risk, usually through credit enhancement techniques, and the use of trusts and special purpose entities to address tax issues and the management of cash flows.

Examiners performing a comprehensive review of a specific securitization process should read through the pooling and servicing agreement and/or a specific series supplement for explicit detail on the structure and design of the particular asset-backed security and the responsibilities of each involved party. For purposes of this booklet, the following is an overview of the structuring process and a description of what the documents usually contain.

Generally, the structure of a transaction is governed by the terms of the pooling and servicing agreement and, for master trusts, each series supplement. The pooling and servicing agreement is the primary contractual document between the seller/servicer and the trustee. This agreement documents the terms of the sale and the responsibilities of the seller/servicer. For master trusts, the pooling and servicing agreement, including the related series supplement, document the terms of the sale and responsibilities of the seller/servicer for a specific issuance. The following section describes the four major stages of the structuring process:

- Segregating the assets from the seller/originator.
- Creating a special-purpose vehicle to hold the assets and protect the various parties' interests.
- Adding credit enhancement to improve salability.
- Issuing interests in the asset pool.

## Segregating the Assets

Securitization allows investors to evaluate the quality of a security on its own (apart from the credit quality of the originator/seller). To accomplish this, the seller conveys receivables to a trust for the benefit of certificate holders. For revolving-type assets, this conveyance includes the amount of receivables in certain designated accounts on a specific cutoff date, plus the option for the trust to purchase any new receivables that arise from those designated accounts subsequent to the cutoff date. The accounts and receivables are subject to eligibility criteria and specific representations and warranties of the seller.

## Choosing Accounts — Initial Pool Selection

The seller designates which accounts' receivables will be sold to a trust. The selection is carried out with an eye to creating a portfolio whose performance is not only predictable but also consistent with the target quality of the desired security. Step one is determining which accounts will be "designated" as those from which receivables may be included in the trust. For example, past-due receivables may be left in the eligible pool, but accounts that have had a default or write-off may be excluded. Some issuers include written-off receivables, allowing the revenue from recoveries to become part of the cash flow of the trust. Other selection criteria might include data elements such as geographic location, maturity date, size of the credit line, or age of the account relationship.

Step two, asset selection, can either be random, in order to create selections that are representative of the total portfolio, or inclusive, so that all qualifying receivables are sold. In random selection, the issuer determines how many accounts are needed to meet the target value of the security; then the accounts are selected randomly (for example, every sixth account is selected from the eligible universe).

## Account Additions and Removals

For trusts with a revolving feature, such as credit cards or home equity lines of credit, the seller may be required to designate additional accounts that will be assimilated by the trust. This may be required for a variety of reasons, for example, when the seller's interest (the interest in the receivables pool retained by the seller subsequent to transfer into the trust) falls below a level specified in the pooling and servicing agreement. The seller also typically reserves the ability to withdraw some accounts previously designated for the trust.[1] Rating agencies must often be notified when account additions or removals reach certain thresholds. For example, the terms of the rating may

[1] The issue of whether provisions for the removal of accounts are in-substance call options retained by the seller (which may compromise sales treatment) is under consideration by FASB at the time of this writing. A formal FASB interpretation is expected to be issued in exposure draft form. Until then, the guidance under Emerging Issues Task Force (EITF) Issue 90-18 remains in effect.

require rating agency confirmation that account additions or removals do not lower outstanding ratings when additions or removals exceed 15 percent of the balance at the beginning of the previous quarter.

## Creating Securitization Vehicles

Banks usually structure asset-backed securities using “grantor trusts,” “owner trusts,” or other “revolving asset trusts,” each of which customarily issues different types of securities. In choosing a trust structure, banks seek to ensure that the transaction insulates the assets from the reach of the issuer’s creditors and that the issuer, securitization vehicle, and investors receive favorable tax treatment.

In a *grantor trust*, the certificate holders (investors) are treated as beneficial owners of the assets sold. The net income from the trust is taxed on a pass-through basis as if the certificate holders directly owned the receivables. To qualify as a grantor trust, the structure of the deal must be passive — that is, the trust cannot engage in profitable activities for the investors, and there cannot be “multiple classes” of interest. Grantor trusts are commonly used when the underlying assets are installment loans whose interest and principal payments are reasonably predictable and fit the desired security structure.

In an *owner trust*, the assets are usually subject to a lien of indenture through which notes are issued. The beneficial ownership of the owner trust’s assets (subject to the lien) is represented by certificates, which may be sold or retained by the bank. An owner trust, properly structured, will be treated as a partnership under the Internal Revenue Code of 1986. A partnership, like a grantor trust, is effectively a pass-through entity under the Internal Revenue Code and therefore does not pay federal income tax. Instead, each certificate holder (including the special-purpose corporation) must separately take into account its allocated share of income, gains, losses, deductions, and credits of the trust. Like the grantor trust, the owner trust is expressly limited in its activities by its charter, although owner trusts are typically used when the cash flows of the assets must be “managed” to create “bond-like” securities. Unlike a grantor trust, the owner trust can issue securities in multiple series with different maturities, interest rates, and cash flow priorities.

*Revolving asset trusts* may be either stand-alone or master trust structures. The stand-alone trust is simply a single group of accounts whose receivables are sold to a trust and used as collateral for a single security, although there may be several classes within that security. When the issuer intends to issue another security, it simply designates a new group of accounts and sells their receivables to a separate trust. As the desire for additional flexibility, efficiency, and uniformity of collateral performance for various series issued by the same originator has increased over time, the stand-alone structure evolved into the master trust structure.

Master trusts allow an issuer to sell a number of securities (and series) at different times from the same trust. All of the securities rely on the same pool of receivables as collateral. In a master trust, each certificate of each series represents an undivided interest in all of the receivables in the trust. This structure provides the issuer with much more flexibility, since issuing a new series from a master trust costs less and requires less effort than creating a new trust for every issue. In addition, credit evaluation of each series in a master trust is much easier since the pool of receivables will be larger and less susceptible to seasonal or demographic concentrations. Credit cards, home equity lines of credit, and other revolving assets are usually best packaged in these structures. A revolving asset trust is treated as a “security arrangement” and is ignored for tax purposes. (See following discussion under “Tax Issues.”)

**Legal Issues**

When banks are sellers of assets, they have two primary legal concerns. They seek to ensure that:

- A security interest in the assets securitized is perfected.
- The security is structured so as to preclude the FDIC’s voiding of the perfected security interest.

By perfecting security interests, a lender protects the trustee’s property rights from third parties who may have retained rights that impair the timely payment of debt service on the securities. Typically, a trustee requires a legal opinion to the effect that the trust has a first-priority perfected security interest in the pledged receivables. In general, filing Uniform Commercial Code documents (UCC-1) is sufficient for unsecured consumer loan receivables such as credit cards. For other types of receivables whose collateral is a reliable fall-back repayment source (such as automobile loans and home equity lines of credit), additional steps may be required (title amendments, mortgage liens, etc.) to perfect the trustee's security interest in the receivables and the underlying collateral.

If the seller/originator is a bank, the provisions of the U.S. Bankruptcy Code (11 USC 1 *et seq.*) do not apply to its insolvency proceedings. In the case of a bank insolvency, the FDIC would act as receiver or conservator of the financial institution.[2] Although the Federal Deposit Insurance Act does not contain an automatic stay provision that would stop the payout of securities (as does the bankruptcy code), the FDIC has the power to ask for a judicial stay of all payments or the repudiation of any contract. In order to avoid inhibiting securitization, however, the FDIC has stated[3] that it would not seek to void an otherwise legally enforceable and perfected security interest provided:

- The agreement was undertaken in the ordinary course of business, not in contemplation of insolvency, and with no intent to hinder, delay, or defraud the bank or its creditors;
- The secured obligation represents a bona fide and arm's length transaction;
- The secured party or parties are not insiders or affiliates of the bank;
- The grant of the security interest was made for adequate consideration; and
- The security agreement evidencing the security interest is in writing, was duly approved by the board of directors of the bank or its loan committee, and remains an official record of the bank.

2 A national bank may not be a "debtor" under the bankruptcy code. *See* USC 109(b)(2). The FDIC may act as receiver or conservator of a failed institution, subject to appointment by the appropriate federal banking agency. *See* 12 USC 1821.

3 "Statement of Policy regarding Treatment of Security Interests after Appointment of the FDIC as Conservator or Receiver." March 31, 1993, 58 FR 16833.

## Tax Issues

Issuers ordinarily choose a structure that will minimize the impact of taxes on the security. Federal income tax can be minimized in two principal ways — by choosing a vehicle that is not subject to tax or by having the vehicle issue "debt" the interest on which is tax deductible (for the vehicle or its owners).

In a grantor trust, each certificate holder is treated as the owner of a pro rata share of the trust's assets and the trust is ignored for tax purposes. To receive the favorable tax treatment, each month the grantor trust must distribute all principal and interest received on the assets held by the trust. A grantor trust is not an "entity" for federal tax purposes; rather, its beneficiaries are treated as holders of a ratable share of its assets (in contrast to partnerships, which are treated as entities, even though their income is allocated to the holders of the partnership interests). The requirement that the trust be "passive" generally makes the grantor trust best suited for longer-term assets such as mortgages or automobile receivables.

An owner trust generally qualifies as a partnership for tax purposes. Because the issuer usually retains an interest in the assets or a reserve account, it is usually a partner; if so, the transfer of assets to the trust is governed by tax provisions on transfers to partnerships. Although the partnership itself would generally not be subject to tax, its income (net of deductions for interest paid to note holders) would be reportable by the partner certificate holders and the issuer. Partnership owner trusts are commonly used in fixed pool transactions involving the same kinds of assets that are securitized through grantor trusts; assets in owner trusts typically require more management or will be issued as more than one class of security.

The cash flows for shorter-term assets, such as credit cards, require too much management for a grantor trust. Although owner trusts are theoretically the appropriate vehicle for issuing such assets, in practice revolving asset trusts are usually used when the parties structure the transaction *for tax purposes* as a secured loan from the investors to the seller of the receivables. The trust is simply a means of securing financing and is ignored for tax purposes. (Such treatment — as a "security arrangement" — is like that accorded a grantor trust, which is also ignored for tax purposes, except that a grantor trust must file a tax report and a "security arrangement" does not.)

Assets requiring managed cash flows can also be structured as a special-purpose corporation (SPC), in which the asset-backed securities are debt of the issuer rather than ownership interests in the receivables. In this structure an SPC typically owns the receivables and sells debt that is backed by the assets, thus allowing the SPC to restructure the cash flows from the receivables into several debt tranches with varying maturities. The interest income from the receivables is taxable to the corporation, and this taxable income is largely offset by the tax deduction from the interest expense on the debt it issues.

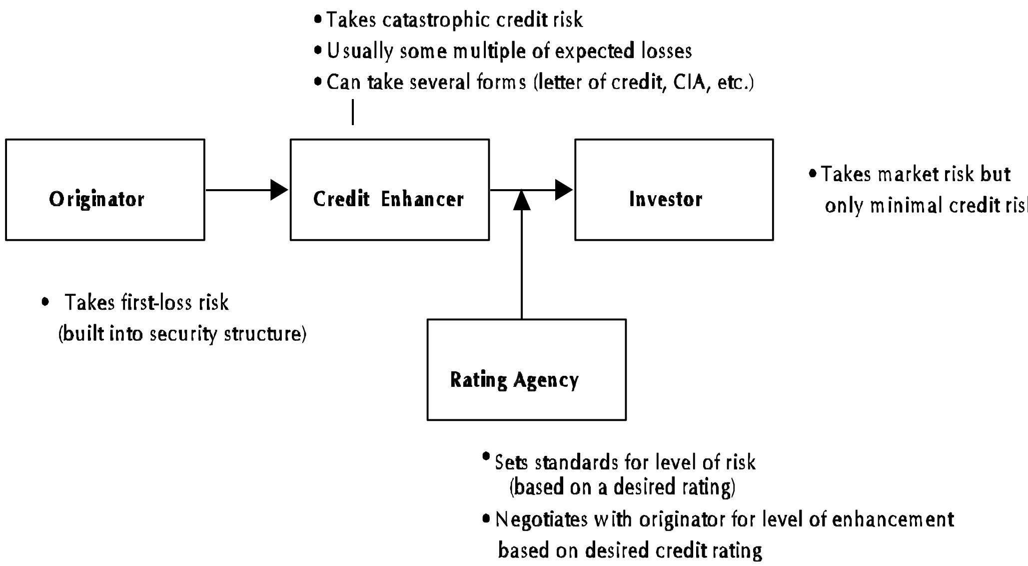
Other securitization vehicles, such as real estate mortgage investment conduits (REMICs) and, more recently (effective September 1, 1997), financial asset securitization investment trusts (FASITs), are essentially statutory structures modeled after the “common law” structures described in the foregoing examples. In any event, the overriding objective remains the same: to receive the equivalent of “flow-through” treatment that minimizes the tax consequences for the cash flows. Because interpretations concerning tax treatment may change as structures evolve, banks are encouraged to consult with tax counsel on taxation issues arising from securitization.

## Providing Credit Enhancement

Securitization typically splits the credit risk into several tranches, placing it with parties that are willing or best able to absorb it. The first loss tranche is usually capped at levels approximate to the “expected” or “normal” rate of portfolio credit loss. All credit losses up to this point are effectively absorbed by the credit originator, since it typically receives portfolio cash flow after expenses (which include expected losses) in the form of excess spread.

The second tranche typically covers losses that exceed the originator’s cap. This second level of exposure is usually capped at some multiple of the pool’s expected losses (customarily between three times and five times these losses), depending on the desired credit ratings for the senior positions. This risk is often absorbed by a high-grade, well-capitalized credit enhancer that is able to diversify the risk (exhibit 3). The third tranche of credit risk is

**Exhibit 3: Credit risk diversification**




undertaken by the investors that buy the asset-backed securities themselves. Although investors are exposed to other types of risk, such as prepayment or interest rate risk, senior-level classes of asset-backed securities typically have little exposure to credit loss.

Aside from the coupon rate paid to investors, the largest expense in structuring an asset-backed security is the cost of credit enhancement. Issuers are constantly attempting to minimize the costs associated with providing credit protection to the ultimate investors. Credit enhancement comes in several different forms, although it can generally be divided into two main types: external (third-party or seller's guarantee) or internal (structural or cash-flow-driven). Common types of credit enhancements in use today include:

**Credit Enhancement Provided by External Parties**

- *Third-party letter of credit.* For issuers with credit ratings below the level sought for the security issued, a third party may provide a letter of credit to cover a certain amount of loss or percentage of losses. Draws on the letter of credit protection are often repaid (if possible) from excess cash flows from the securitized portfolio.

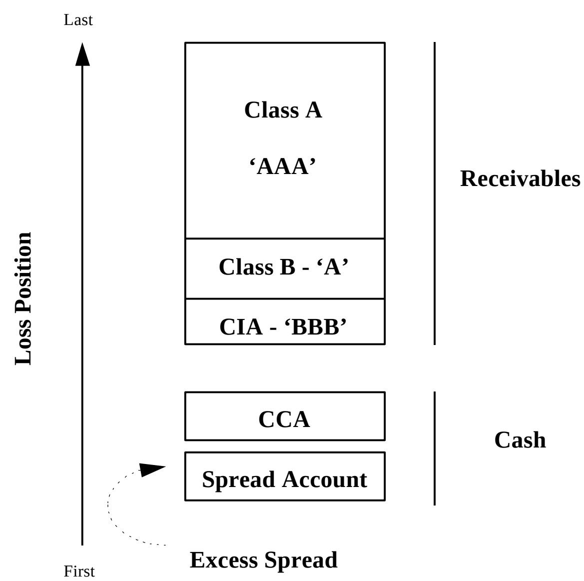
- *Recourse to seller.* Principally used by nonbank issuers, this method uses a limited guaranty of the seller covering a specified maximum amount of losses on the pool.

- *Surety bonds*. Guarantees issued by third parties, usually AAA-rated mono-line insurance companies. Surety bond providers generally guarantee (or wrap) the principal and interest payments of 100 percent of a transaction.

Although the ratings of third-party credit enhancers are rarely lowered, such an event could lower the rating of a security. As a result, issuers are relying less and less on third-party enhancement.

**Credit Enhancement Provided by Internal Structure**

Structural features can be created to raise the credit quality of an asset-backed security. For example, a highly rated senior class of securities can be supported by one or more subordinate security classes and a cash collateral account. Senior/subordinate structures are layered so that each position benefits from the credit protection of all the positions subordinate to it. The junior positions are subordinate in the payment of both principal and interest to the senior positions in the securities.




A typical security structure may contain any of the following internal enhancements (which are presented in order from junior to senior, that is, from the first to absorb losses to the last):

1. *Excess spread*. The portfolio yield for a given month on the receivables supporting an asset-backed security is generally greater than the

coupon, servicing costs, and expected losses for the issued securities. Any remaining finance charges after funding, servicing costs, and losses is called "excess spread." (See the cash flow waterfall discussion in the "Mechanics of Cash Flow" section, which follows, for an illustration of how excess spread is determined.) This *residual* amount normally reverts to the seller as additional profit. However, it is also commonly available to the trust to cover unexpected losses.

2. *Spread account*. Monthly finance charges from the underlying pool of receivables are available to cover unexpected losses in any given month. If not needed, this "excess spread" generally reverts to the seller. Many trusts provide that, if portfolio yield declines or losses increase, the monthly excess spread is captured, or "trapped," in a spread account (a form of cash collateral account) to provide future credit enhancement.

3. *Cash collateral accounts*. A cash collateral account is a segregated trust account, funded at the outset of the deal, that can be drawn on to cover shortfalls in interest, principal, or servicing expense for a particular series if excess spread is reduced to zero. The account can be funded by the issuer, but is often funded by a loan from a third-party bank, which will be repaid only after holders of all classes of certificates of that series have been repaid in full.

4. *Collateral invested amount (CIA).* The CIA is an uncertificated, privately placed ownership interest in the trust, subordinate in payment rights to all investor certificates. Like a layer of subordination, the CIA serves the same purpose as a cash collateral account: it makes up for shortfalls if excess spread is negative. The CIA is itself often protected by a cash collateral account and available monthly excess spread. If the CIA absorbs losses, it can be reimbursed from future excess spread if available.

5. *Subordinate security classes.* Subordinate classes are junior in claim to other debt — that is, they are repayable only after other classes of the security with a higher claim have been satisfied. Some securities contain more than one class of subordinate debt, and one subordinate class may have a higher claim than other such positions.

Most structures contain a combination of one or more of the enhancement techniques described above. For example, some issuers combine surety bond protection with senior/subordinate structures, creating “super senior” classes that are insulated from third-party risk and have higher rated subordinated classes because of the credit-wrap. The objective from an issuer’s viewpoint is to find the most practical and cost-effective method of providing the credit protection necessary for the desired credit rating and pricing of the security.

Most securities also contain performance-related features designed to protect investors (and credit enhancers) against portfolio deterioration. These “performance triggers” are designed to increase the spread account available to absorb losses, to accelerate repayment of principal before pool performance would likely result in losses to investors, or both. The first (most sensitive) triggers typically capture excess spread within the trust (either additions to existing spread accounts or a separate reserve fund) to provide additional credit protection when a portfolio begins to show signs of deterioration. If delinquencies and loss levels continue to deteriorate, early amortization events may occur. Early amortization triggers are usually based on a three-month rolling average to ensure that amortization is accelerated only when performance is consistently weak.

The originator or pool sponsor will often negotiate with the rating agencies about the type and size of the internal and external credit enhancement. The size of the enhancement is dictated by the credit rating desired. For the highest triple-A rating, the rating agencies are likely to insist that the level of protection be sufficient to shield cash flows against circumstances as severe as those experienced during the Great Depression of the 1930s.

## Issuing Interests in the Asset Pool

On the closing date of the transaction, the receivables are transferred, directly or indirectly, from the seller to the special-purpose vehicle (trust). The trust issues certificates representing beneficial interests in the trust, investor certificates, and, in the case of revolving asset structures, a transferor (seller) certificate.

### Investors' Certificate

The investor certificates are sold in either public offerings or private placements, and the proceeds, net of issuance expenses, are remitted to the seller. There are two main types of investor interests in securitized assets — a discrete interest in *specific* assets and an undivided interest in a *pool* of assets. The first type of ownership interest is used for asset pools that match the maturity and cash flow characteristics of the security issued. The second type of interest is used for relatively short-term assets such as credit card receivables or advances against home equity lines of credit. For the shorter-term assets, new receivables are generated and added to the pool as the receivables liquidate, and the investor's undivided interest automatically applies to the new receivables in the pool.

### Seller's Interest

When receivables backing securities are short-term or turn over rapidly, as do trade receivables or credit cards, the cash flows associated with the receivables must be actively managed. One objective is to keep the outstanding principal balance of the investor's interest equal to the certificate amounts. To facilitate this equalization, an interest in trust structures, known as the "seller's" or "transferor's" interest, is not allocated to investors. The seller's interest serves two primary purposes: to provide a cash-flow buffer when account payments fall short of account purchases and to absorb reductions in the receivable balance attributable to dilution and noncomplying receivables.

To calculate the size of the seller's interest, subtract the amount of securities issued by the trust (liabilities) from the balance of principal receivables in the trust (assets). The seller's interest is generally not a form of credit enhancement for the investor interests.

## The Mechanics of Cash Flow

### Cash Flow Allocations

#### Pass-Through Securities

The payment distribution for securities backed by installment loans is closely tied to the loans' payment flows. Interest is customarily paid monthly, and the principal included in each payment will depend on the amortization schedule and prepayment rate of the underlying collateral.

#### Pay-Through Securities

For revolving asset types such as credit cards, trade receivables, and home equity lines, the cash flow has two phases:

- The revolving period; and
- The principal pay-down period (amortization phase).

During the revolving period, investors receive their pro rata share of the gross portfolio yield (see below) based on the principal amount of their certificates and the coupon rate. The remaining portion of their share of the finance charges above the coupon rate is available to pay the servicing fees and to cover any charge-offs, with residual amounts generally retained by the seller or credit enhancement provider as excess spread. This distribution of cash is often referred to as the "cash flow waterfall."

The cash flow waterfall for credit card securities may look like this (percentages based on investor's pro rata share of outstanding receivables):

*Revenue*

| | |
|---|---|
| Finance Charges | 16.5%* |
| Annual Fees | 1.5% |
| Late Fees and Other Fees | 0.7% |
| Interchange | 1.8% |
| **Gross Portfolio Yield (finance charges)** | **20.5%** |

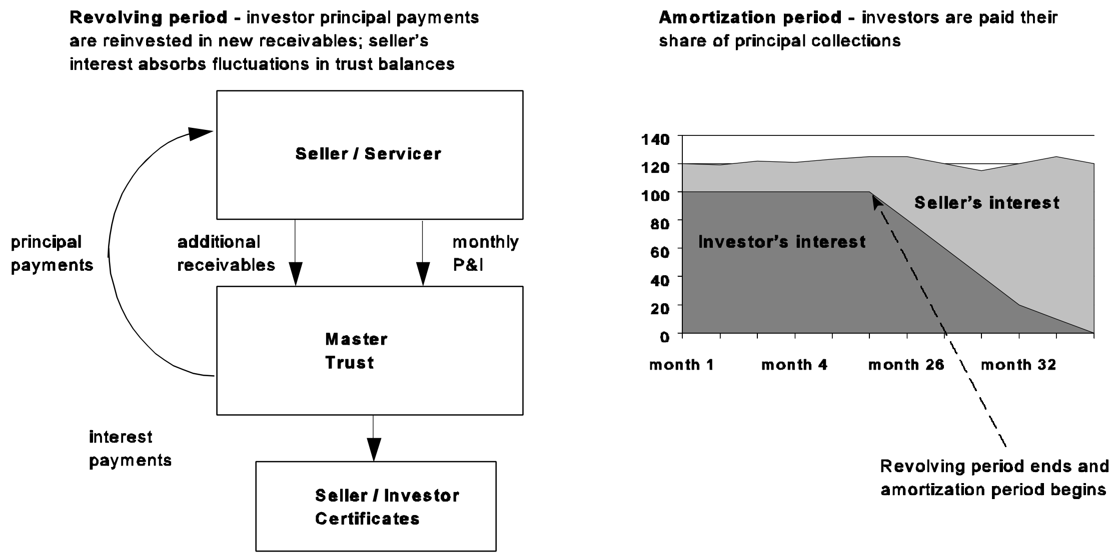
*Expenses*

| | | |
|---|---|---|
| Investor Coupon | 7.0%* | |
| Servicing Expense | 2.5% | |
| Charge-offs | 5.0% | |
| **Total Expenses** | | **14.5%** |
| **Excess Spread** | | **6.0%** |

During the revolving period, monthly principal collections are used to purchase new receivables generated in the designated accounts or to purchase a portion of the seller's participation if there are no new receivables. If the percentage of the seller's interest falls below a prescribed level of principal outstanding because of a lack of new borrowings from the designated accounts, new accounts may be added.

After this revolving period comes the amortization period. During this phase, the investors' share of principal collections are no longer used to purchase replacement receivables. These proceeds are returned to investors as received. This is the simplest form of principal repayment. However, because over time investors have preferred more stable returns of principal, some issuers have created structures to accumulate principal payments in a trust account ("accumulation account") rather than simply passing principal payments through to investors as received. The trust then pays principal on a specific, or "bullet," maturity date. Bullet maturities are typically either "hard" or "soft," depending on how the structure compensates when funds in the accumulation account are not sufficient to pay investors in full on the scheduled maturity date. Under a hard bullet structure, a third-party maturity guaranty covers the shortfall. Under a soft bullet structure, the entire accumulation account is distributed to the investors and further funds are paid as received. Soft bullet structures usually include an expected maturity date and a final maturity date.

**Exhibit 4: The Two Stages of a Revolving-Receivable Asset-Backed Security**




## Early Amortization Protection

In addition to the previously discussed credit enhancement types, revolving asset-backed securities typically use early amortization triggers to protect investors from credit risk. These triggers, or payout events, accelerate the repayment of investor principal if cash flow from the pool declines or the condition of the pooled assets deteriorates. This accelerated repayment method requires that the investors' share of all principal collections be returned immediately as it is received by the trust. The payout events are defined in the pooling and servicing agreement and series supplement of each securitization, and are intended to protect investors from prolonged exposure to deteriorating performance of the underlying assets or the default of a servicer.

To monitor the asset-backed security's performance, the trustee, the rating agencies, and investors focus on several indicators of pool performance: portfolio yield, the loss rate, the monthly payment rate, and the purchase rate.

- *Portfolio yield* generally consists of three types of payments: finance charges, fees, and interchange. Finance charges are the periodic interest costs associated with an unpaid balance at the end of a grace period. Fees include annual membership fees, late payment fees, cash advance transaction fees, and over-limit fees. Interchange is the fee paid by merchants and passed to the card-issuing bank for completing the transaction.

- *Loss rates* are evaluated relative to the seasoning of the pool and the marketing and underwriting strategies of the originator. Rating agencies pay particular attention to estimated and actual loss rates when settling on credit enhancement levels and monitoring securities for potential ratings actions.

- The *monthly payment rate* includes monthly collections of principal, finance charges, and fees paid by the borrower. Payment rate monitoring is focused on principal collections since it is principal repayments that will be used to pay down the investor's outstanding principal.

- The *purchase rate* is the amount of new charges transferred to the trust each month from the designated accounts as a percent of the receivables outstanding. New purchases keep the amount of principal receivables in the trust from falling. If the pool balance falls below a minimum, the seller is usually required to assign additional accounts to the pool.

Other items of interest are finance charge and principal allocations among the various interests in the trust and, for floating rate issues, coupon rates. Should any of the aforementioned indicators show prolonged signs of deterioration by tripping a preset trigger, early amortization would begin.

Common early amortization triggers include:

- A reduction in the portfolio yield (net of defaults) below a base rate (investor coupon plus the servicing fee) averaged over a three-month period.
- A reduction in the seller's interest below a fixed percentage of the total principal receivables outstanding.

- A failure of the seller, servicer, or the credit enhancement provider to perform as required by the terms of the pooling and servicing agreement.

An early return of principal is not always welcomed by investors, so a well-structured agreement should balance the need for predictable repayment with the need to maintain satisfactory credit quality.

## Impact of Securitization on Bank Issuers

Properly managed, securitization enables a bank to originate a higher volume of assets while managing deposit insurance and reserve requirement costs; reducing credit risk, liquidity risk, and interest rate risk; diversifying funding sources and tenors; and maintaining (and expanding) customer relationships. The net effects of these benefits can be improved return-on-asset and return-on-equity ratios, enhanced customer service, and reduced exposure to concentration risks.

Examiners should be aware, however, that management at some banks may overestimate the risk transfer of securitization or may underestimate the commitment and resources required to effectively manage the process. Such mistakes may lead to highly visible problems during the life of the transaction that could impair future access to the securitization markets as a funding source. The risks faced by a bank will largely be a function of the roles they play in the transaction and the quality of the underlying assets they originate and/or service. The objective of the risk management evaluation performed by examiners should be to assess the impact of all aspects of securitization on the overall financial condition and performance of the institution.

### Process Management

Banks that have been able to exploit the full range of benefits offered by securitization typically view the process as a broad-based strategic initiative. As part of this approach they have integrated their risk management systems into all facets of the securitization process.

#### New Product Evaluation

First-time securitizers should ensure that the proposed process has been thoroughly reviewed before the first transaction. The business plan for securitization (or for introducing any new product) should detail the business rationale, how existing policies should be modified, a performance measurement process, a list of potential counterparties (credit enhancers, underwriters, trustees, etc.), and assurances that the bank has adequate controls and procedures, systems, and risk analysis techniques. The business proposal should at least provide a description of:

- The proposed products, markets, and business strategy;
- The risk management implications;
- The methods to measure, monitor, and control risk;
- The accounting, tax, and regulatory implications;
- Any legal implications; and
- Any necessary system enhancements or modifications.

All relevant departments should review and approve the proposal. Key parties normally include the risk oversight function, operations, information technology, finance/accounting, legal, audit, and senior line management. A rigorous approval process for new products or activities lessens the risk that bank management may underestimate the level of due diligence required for risk management or the ongoing resources required for process management.

### Responsibility and Accountability

While ad hoc committees often form the initial steering group for a securitization transaction, proficient issuers usually assign responsibility for managing securitization to a dedicated individual or department. This manager (or group) should have the experience and skills to understand the various components of securitization and the authority to communicate and act across product and department lines. The manager should consider the effects that proposed changes in policies or procedures on origination or servicing may have on outstanding or future securitization issues. He or she should communicate observations and conclusions to senior management.

### Oversight

All risk management programs should be independently monitored and evaluated, usually by an internal audit unit or another risk control unit. The control group determines whether internal control practices are in accordance with risk management policies, whether controls are adequate, whether risk levels are accurately estimated, and whether such levels are appropriate.

To facilitate the development of internal controls, risk managers should be informed about the securitization process at the earliest possible stage. During the initial due diligence for a securitization transaction, the underwriter (often an investment banker), the rating agencies, and the independent outside accountants thoroughly review the bank's securitization process. Their review, however, takes place primarily in the early stages of the process; they do little direct review after the initial transaction is complete. At that point, the bank's internal oversight takes on vast importance.

The bank's risk control unit should report directly to a senior executive to ensure the integrity of the process. The unit, which should evaluate every role the bank has in securitization, should pay special attention to the origination and servicing operations. In the origination area, the unit should take significant samples of credit decisions, verify information sources, and track the approval process. In the servicing area, the unit should track payment processing, collections, and reporting from the credit approval decision through the management and third-party reporting process. The purpose of these reviews is to ensure that activities are consistent with policy and trust agreements and to detect operational weaknesses that leave the bank open to fraud or other problems. Risk managers often suggest policies or procedures to prevent problems, such as documenting exceptions to bank policies. Any irregularities discovered in the audits should be followed up and discussed with senior management.

### Monitoring of Securitization Transactions

Management reports should monitor the performance of the underlying asset pools for all outstanding deals. Although the bank may have sold the ownership rights and control of the assets, the bank's reputation as an underwriter or servicer remains exposed. To control the impact of deterioration in pools originated or serviced by the bank, a systematic reporting process allows management to track pool quality and performance throughout the life of the transactions.

Reports on revolving transactions (credit cards, home equity lines, etc.) should monitor:

- The portfolio's gross yield;
- Delinquencies;
- The charge-off rate;
- The base rate (investor coupon plus servicing fees);
- Monthly excess spread;
- The rolling three-month average excess spread; and
- The monthly payment rate.

Reports on securities backed by installment loans (automobiles, equipment leases, etc.) should monitor:

- The charge-off rate;
- The net portfolio yield (portfolio yield minus charge-offs);
- Delinquencies (aged);
- Principal prepayment speeds; and
- Outstanding principal compared to original security size.

### Communication with Outside Parties

To maintain market confidence, reputation, and the liquidity of securities, issuers and servicers should be able to supply accurate and timely information about the performance of underlying assets to investors, rating agencies, and investment bankers. The bank's cost of accessing the capital markets can depend on this ability. The securitization manager or management unit should regularly verify information on performance.

## Risks and Controls

Although it is common for securitization transactions to receive substantial attention early in their lives, the level of scrutiny generally declines over time. Many of the problems that institutions have experienced, such as rising delinquencies and charge-offs, inaccurate investor reporting, and bad publicity, have occurred in the later stages of the transaction. The bank should supervise and monitor a transaction for the duration of the institution's involvement.

Examiners assess banking risk relative to its impact on earnings and capital. From a supervisory perspective, risk is the potential that events, expected or unanticipated, will have an adverse impact on the bank's earnings or capital. The primary risks associated with securitization activities are reputation, strategic, credit, transaction, liquidity, and compliance. The types and levels of risk to which a particular banking organization is exposed will depend upon the organization's role or roles in the securitized transactions. The definitions of these risks and their pertinence to securitization are discussed below. For more complete definitions, see the "Bank Supervision Process" booklet of the *Comptroller's Handbook*.

## Reputation Risk

Reputation risk is the risk to earnings or capital arising from negative public opinion. This affects the institution's ability to establish new relationships or services or continue servicing existing relationships. This risk can expose the institution to litigation, financial loss, or damage to its reputation. Reputation risk is present throughout the organization and includes the responsibility to exercise an abundance of caution in dealing with its customers and community.

### Nature of Reputation Risk

Exposure to reputation risk is essentially a function of how well the internal risk management process is working in each of the other risk categories and the manner and efficiency with which management responds to external influences on bank-related transactions. Reputation risk has a "qualitative" nature, reflecting the strength of an organization's franchise value and how it is perceived by other market participants. This perception is usually tied to performance over time. Although each role a bank plays in securitization places its reputation on the line, it stakes its reputation most heavily on the quality of the underlying receivables and the efficiency of its servicing or other fiduciary operations.

Asset performance that falls short of expectations will reflect poorly on the underwriting and risk assessment capabilities of the originator. Because the asset performance of securitized pools is publicly disclosed and monitored by market participants, securitization can highlight problems that were less obvious when reported as a smaller component of overall portfolio performance.

The best evidence of positive or negative perception is how the market accepts and prices newly issued asset-backed securities. Poorly performing assets or servicing errors on existing transactions can increase the costs and decrease the profitability of future deals. Reputation as an underwriter or servicer is particularly important to issuers that intend to securitize regularly. For some issuers, negative publicity from securitization transactions may cause the market to avoid other liability as well as equity issuances.

### Managing Reputation Risk

The most effective method of controlling reputation risk is a sound business plan and a comprehensive, effective risk management and control framework that covers all aspects of securitization activities. Up-front effort will minimize the potential for unexpected errors and surprises, most of which are quite visible to public market participants.

Management of reputation risk often involves business decisions that extend beyond the technical, legal, or contractual responsibilities of the bank. For securitization activities, problems are most often associated with revolving assets. Although the bank has transferred legal liability for performance of such receivables, it is nevertheless closely associated with the assets through servicing, through replacement receivables sales, or simply by name. Decisions to protect franchise value by providing additional financial support should be made with full recognition of the potential long-term market, accounting, legal, and regulatory impacts and costs.

## Strategic Risk

Strategic risk is the risk to earnings and capital arising from adverse business decisions or improper implementation of those decisions. This risk is a function of the compatibility of an organization's strategic goals, the business strategies developed to achieve those goals, the resources deployed against those goals, and the quality of implementation. The resources needed to carry out business strategies are both tangible and intangible. They include communication channels, operating systems, delivery networks, and managerial capacities and capabilities.

**Nature of Strategic Risk**

To assess a bank's strategic risk exposure, one must recognize the long-term impacts of securitization on operations, profitability, and asset/liability management. Such exposure increases if transactions are undertaken without considering the long-term internal resource requirements. For example, while the existing systems in the credit and collections department may be adequate for normal operations, securitization transactions are often accompanied by rapid growth in the volume of transactions and more timely and precise reporting requirements. At a minimum this may require improved computer systems and software and dedicated operational and treasury personnel. Business and strategic plans should delineate the long-term resources needed to handle the projected volume of securitization.

Decisions on credit quality and origination also expose a bank to strategic risk. The availability of funding, the opportunity to leverage systems and technology, and the ability to substantially increase fee income through securitization should not lure issuers into a business line about which they don't have sufficient knowledge. For example, banks that are successful at underwriting and servicing 'A' quality paper may not be as successful with 'B/C' paper, because different skills are needed to service higher risk loans. Banks that have been successful in entering new product lines are those that have first acquired the necessary expertise.

Competition is a prime source of strategic risk. Securitization provides economical funding to a far greater pool of credit originators than banks have traditionally had to compete against. The long-term effects of this greater competition may be to erode profit margins and force banks to seek further efficiencies and economies of scale. Tighter profitability margins diminish the room for error, increasing the importance of strategy. Many market participants (including banks) will be forced to find where their competitive advantages lie and what new or additional skills they need to compete.

### Managing Strategic Risk

Before initiating a securitization transaction, management should compare the strategic and financial objectives of proposed securitization activities with the risk exposures and resource requirements. A thorough analysis would include the costs of the initial transaction and any systems or technology upgrades necessary to fulfill servicing obligations. Because securitization affects several different areas in a bank, the assessment should describe the responsibilities of each key person or department. Each manager responsible for an area involved in the securitization process should review the assessment.

## Credit Risk

Credit risk is the risk to earnings or capital arising from an obligor's failure to meet the terms of any contract with the bank or otherwise to perform as agreed. Credit risk is found in all activities where success depends upon counterparty, issuer, or borrower performance. It arises any time bank funds are extended, committed, invested, or otherwise exposed through actual or implied contractual agreements, whether on or off the balance sheet.

One of the primary benefits of securitization is its usefulness in managing credit risk exposure. For example, overall portfolio quality may improve because of the opportunity to diversify exposure to a particular industry (e.g., oil and gas, real estate, retail credit, etc.) or geographic area. Securitization structures reduce the credit exposure of the assets sold by transferring the unexpected portion of the default risk to credit enhancement providers and investors. Effective risk management requires recognizing the extent and limits of this risk transfer and planning for the capital and other resource requirements necessary to support the remaining risk levels.

### Nature of Credit Risk

Although financial reporting and regulatory risk-based capital practices are useful indicators of the credit impact of securitization on a bank, these guidelines do not fully capture the economic dimensions of the originator's exposure to credit risk from a sale of securitized assets. Although important, an examiner's inquiry should extend beyond whether the sale of assets is accounted for on or off the balance sheet. It should assess the fundamental residual credit risks left with the bank after the transaction. In addition, the assessment should be made in the context of a total return standard rather than focusing solely on absolute loss and delinquency levels. For example, some pools, such as sub-prime automobile loans, are expected to have relatively high loss and delinquency rates. These pools, if properly underwritten, can be economically successful as long as the pricing and structure of the loans reflects the inherent risks.

A bank that sells assets in a securitization transaction confronts three main forms of credit risk:

- Residual exposure to default.
- Credit quality of the remaining on-balance-sheet portfolio.
- Possibility that it will have to provide moral recourse.

*Default Exposure*. Securitizing banks must evaluate how much default risk remains with them after a sale. Quantifying the residual default risk or contingent liability requires an in-depth review of the cash flow structure of the transaction and its third-party support. In most structures, credit risk is allocated so that the originator bears default losses up to a certain point, typically based on historic losses and projected performance. The first loss exposure assumed by the originator is a function of its acceptance of excess portfolio yield as a residual interest, that is, after the coupon and servicing expense are paid and loan losses are calculated. As pool performance deteriorates and charge-offs increase, excess spread (which could eventually return to the bank) declines.

Subject to certain structural provisions, excess spread may be diverted to fund or supplement cash collateral accounts for the benefit of investors and credit enhancers. Once excess spread is exhausted, the risks of credit default customarily shift to credit enhancers up to some additional multiple of projected losses. Only defaults above these multiples are borne by investors. As previously discussed, other protective measures, such as early amortization provisions, insulate investors and, to some extent, credit enhancers. Since losses of the magnitude required to trigger early amortization are infrequent, originators effectively absorb a substantial portion of realized losses in most securitized pools.

*Remaining Asset Quality.* Securitization readily lends itself to high-quality assets that provide a predictable, steady cash flow stream. Higher and more predictable net cash flows translate into lower credit enhancement fees and higher excess spread income. This may tempt banks to securitize the better-quality assets while keeping lower quality assets on the balance sheet. Because a bank new to the securitization markets does not have a track record with investors, it may be especially inclined to do so. If this approach becomes a habit, the bank will be required to hold more capital and loan loss reserves for the assets that remain on the books. Such an approach can compromise the integrity of loan loss reserve analyses that are based on historical performance.

*Moral Recourse.* Most prospectuses on asset-backed securities issued by banks clearly state that *the offering is not an obligation of the originating bank*. Despite this lack of legal obligation, in certain circumstances an originator may feel compelled to protect its name in the marketplace by providing support to poorly performing asset pools. Because there is some precedent in the market for preventing ratings downgrades or early amortization, many investors expect sponsors to aid distressed transactions.

Deciding to provide financial support for sold assets is difficult for banks. In addition to the immediate costs associated with steps to improve the yield on the asset pool, there may be other accounting, legal, and regulatory costs. For example, actions taken to support previously sold assets may compromise both the transaction's legal standing as a sale and the ability to treat the assets as off-balance-sheet items for GAAP and regulatory capital purposes. If this occurs, performance ratios, regulatory capital charges, and perhaps the tax treatment of the transaction may be affected.

Prudent business practice dictates that management consider all of the potential costs of providing additional enhancement to poorly performing asset pools. Not only would the bank supply direct financial support but it may also be obliged by its assumption of greater risk to meet a higher capital requirement. From a practical viewpoint, examiners should recognize that banks may decide to support outstanding securitization transactions to retain access to the funding source, even though doing so may require them to hold additional capital. For example, if bankers were to allow early amortization, they might need to obtain both new funding for the assets returning to the balance sheet and additional risk-based capital. Although such a decision is for management to make, examiners should ensure appropriate risk-based capital levels are maintained for the risks assumed. (See the risk-based capital discussion under “Other Issues” for additional guidance.)

*Other Credit Quality Issues*. Banks can also assume credit risk exposure from securitized asset pools by becoming a credit enhancer for assets originated by a third party. Doing so exposes a bank to credit risk from a pool of loans it had no part in originating. So credit-enhancing banks must understand the transaction structure and perform adequate due diligence, especially when exceptions to underwriting policies and overrides are involved.

### Managing Credit Risk

Because originating banks absorb most of the expected losses from both on-balance-sheet and securitized pools, sound underwriting standards and practices remain the best overall protection against excessive credit exposure. These banks should include experienced credit personnel in the strategic and operating decision-making process. Investment-banker, marketing, or other volume-oriented parties should not drive the process. Often, sustained periods of dramatic growth, aggressive teaser rates, and liberal balance transfer strategies are indications of an easing of underwriting standards. No matter how competitive the market, decisions on credit quality should be careful ones. In effective risk management systems, audit or credit review functions regularly test the lenders’ compliance with underwriting standards for both on- and off-balance-sheet credits.

Most banks recognize the broad effects of securitization on credit risk and strategically attempt to ensure that sold and retained loans are of the same general quality. To protect against the tendency to loosen underwriting standards for pools that lenders believe may be sold, many banks require that all loans be subject to the same loan policy and approval process. To minimize the potential that the quality of securitized and retained loans differ, many banks employ a random selection process to ensure that every pool of assets reflects the overall quality of the portfolio and underwriting standards. If a business decision is made to choose a specific quality of loans for sale, special precautions are warranted.

If the sold loans are of *higher* quality than retained loans, then management should acknowledge the increased level of on-balance-sheet risk by ensuring that the bank's capital level and allowance for loan and lease losses are maintained at appropriate levels. If sold loans are to be *lower* quality than retained loans, the business and/or capital plans should acknowledge the increased vulnerability to moral recourse.

**Other Credit Issues**

*Automated Underwriting Systems*. Because securitization rewards economies of scale and allows a bank to originate a greater volume of receivables, many originators now use automated underwriting systems such as credit scoring and the electronic services of ratings companies such as Dun & Bradstreet. The objective is to speed credit approvals by allowing computers to accept (or reject) the large number of applications that are well within (or outside) the underwriting guidelines. Marginal applications are then processed individually. Use of these systems also improves the ability to predict and model pool performance, which in turn can lower the cost of credit enhancement and security coupon rates.

In addition to loan quality problems, poorly designed automated underwriting and scoring systems can adversely affect some borrowers or groups of borrowers. The bank's CRA policy, or loan policy, should address the needs of low- to moderate-income members of the trade area. The bank should be aware of the possibility of economic redlining, which could be caused, in part, by its desire to conform to the criteria handed down by the secondary market. Compliance reviews should include originations for securitization to ensure compliance with CRA. Automated scoring systems should be managed like other risk management models. For example, they should be tested periodically for continued relevance and validity.

*Stress Testing of Securitized Pools.* Many banks use cash flow models to simulate the structure and performance of their securitized asset pools. These models trace funds through the proposed transaction structure, accounting for the source and distribution of cash flows under many possible scenarios. Because the cash flows from any pool of assets can vary significantly depending on economic and market events, banks often subject proposed structures to severe stress-testing to predict the loss exposures of investors and credit enhancers under most-likely and worst-case scenarios.

The effectiveness of models used to predict the performance of loan pools depends on disciplined adherence to clear underwriting standards for individual loans. Although a potentially powerful tool, models can be misused, become outdated, or skew results because of inaccurate or incomplete information. Any of these factors may cause projections to vary from the actual performance of the asset pool. To control potential weaknesses, management should back-test model results regularly, revalidate the logic and algorithms, and ensure the integrity of data entry/capture and assumptions.

*Vintage Analysis.* Another technique used to monitor loan quality and estimate future portfolio performance is vintage analysis. This type of analysis tracks delinquency, foreclosure, and loss ratios for similar products over comparable time periods. The objective is to identify sources of credit quality problems (such as weak or inappropriate underwriting standards) early so that corrective measures can be taken. Because loan receivables often do not reach peak delinquency levels until they have seasoned for several months, tracking the payment performance of seasoned loans over time allows the bank to evaluate the quality of newer receivables over comparable time periods and to forecast the impact that aging will have on portfolio performance.

*Disclosure vs. Confidentiality*. Most commercial loan files contain a substantial amount of nonpublic information. Much of this information is confidential. Although banks want to honor this confidence, they also feel obligated to disclose all the material information that a prospective investor should know. The problem is less daunting with homogeneous consumer loan products that lend themselves to aggregate performance analysis than it is in the growing markets for small business loans and other commercial loan products.

Bank policy on securitization of commercial loans should address the disclosure of confidential information provided by borrowers that are privately owned companies. The bank should obtain legal advice concerning what information should be disclosed or not disclosed about an issue of securitized loans. Bank counsel should also sign off on decisions whether to inform borrowers of the disclosure of nonpublic information. To avoid problems with large commercial borrowers, bank management may wish to routinely obtain an acknowledgment or release from customers.

## Transaction Risk

Transaction risk is the risk to earnings or capital arising from problems with service or product delivery. This risk is a function of internal controls, information systems, employee integrity, and operating processes. Transaction risk exists in all products and services.

For most securitized asset sales, the responsibility for servicing the assets is retained by the originator. This obligation usually extends throughout the life of the issued securities. Since the fee associated with servicing the portfolio is typically fixed, the risk of inefficiency from an operational point of view is retained by the originator. The length of the obligation and the volume-driven nature of these activities increase the possibility that banks, especially those with limited securitization experience, will overestimate their capacity to meet obligations, will underestimate the associated costs, or both.

### Nature of Transaction Risk

The pooling and servicing agreement is the primary document defining the servicers' responsibilities for most securitization transactions. Transaction risk exposure increases when servicers do not fully understand or fulfill their responsibilities under the terms of this agreement. Servicing difficulties, such as incorrect loan and payment processing, inefficient collection of delinquent payments, or inaccurate investor reporting, expose the servicer to transaction risk. Effective servicing helps to ensure that receivables' credit quality is maintained. The main obligations assumed by the servicing bank are transaction processing, performance reporting, and collections.

*Transaction Processing*. Processing problems can occur when existing bank systems, which were designed to service volumes and types of loans that met certain portfolio objectives and constraints, are now subject to larger volumes or unanticipated loan types. Excessive volume may overextend systems and contribute to human error.

For most deals, the servicer agrees to service and administer the receivables in accordance with its customary practices and guidelines. The servicer also has the responsibility and authority to make payments to and withdrawals from deposit accounts that are governed by the documents. Servicers are typically paid a fixed percentage of the invested amount for their obligation to service the receivables (often between 1.5 percent and 2.5 percent for consumer products such as credit cards). Many bank servicers are highly rated and are able, under the pooling and servicing agreement, to commingle funds until one business day before the distribution date. Those lacking short-term, unsecured ratings of 'A-1' or better must customarily deposit collections in an eligible deposit account at another institution within one or two business days of receipt.

*Reporting.* Bank management, investors, and rating agencies all require that the performance of security pools be reported accurately and in a timely manner. Such reporting can be an especially difficult challenge for first-time issuers or for banks without integrated systems. For example, reporting difficulties have occurred when lead banks or holding companies have attempted to pool loans from various affiliates with different processing and reporting systems, or when bank-sponsored conduits have pooled receivables from various third-party originators. Servicing agreements are usually specific about the timing of payment processing and the types and structures of required reports, and trustees and investors have little tolerance for errors or delays.

*Collections.* A bank may also be exposed to transaction risk when its systems or personnel are not compatible with new types of borrowers or new products. Although securitization often provides incentives to expand activity beyond traditional markets and products, the staff members of some banks have done business only with certain customer types or are used to considerable flexibility in dealing with customers, particularly in workout situations. These bankers may have difficulties adjusting to the restrictions or specific requirements of securitization agreements. For example, the decision to compete for market share by expanding into markets for borrowers with poor credit histories may require a change in collection methods. Front-line relationship managers may be uncomfortable with the labor-intensive methods necessary for long-term success in this market segment, and pool performance may suffer.

The increased transaction volumes and risk transfers associated with securitization have, in some ways, depersonalized the lending and collections process. For example, limiting bankers' ability to work out problems with customers may pose special problems. In order to maintain strong relationships with customers, some bankers may wish to ignore the limits of typical pool requirements in renegotiating repayment terms and collateral positions. If longstanding customer relationships are valuable enough, some bankers may decide to repurchase securitized loans and draw up more flexible workout terms. Management should recognize that decisions to repurchase loans may compromise "sales treatment" for some transactions.

*Liquidity Enhancement.* As part of the servicing agreement, seller/servicers are sometimes obligated to enhance the liquidity of receivables securitized. The purpose of doing so is *not* to protect against deterioration in the credit quality of the underlying receivables but rather to ensure that the security issuer (the trust) will have sufficient funds to pay obligations as scheduled. Funding becomes necessary when the due date of payments to investors arrives before sufficient collections accrue. This liquidity enhancement requires a servicer to make cash advances to the trustee on behalf of obligors who may not pay as scheduled or estimated. However, a servicer can usually exempt itself from making such advances by formally determining that the funds would not be recoverable. In many cases the accuracy of a servicer's "recovery determination" is reviewable by the trustee. If the servicer does advance funds against receivables that later default for credit quality purposes, the liquidity provider obtains the investor's rights to use proceeds from the credit enhancement to repay any advances it has made.

### Managing Transaction Risk

The effective management of servicing obligations requires a thorough understanding of the securitization process and especially the associated information and technology requirements. To reduce the bank's exposure to transaction risk, management should evaluate staffing, skill levels, and the capacity of systems to handle the projected type and volume of transactions.

The largest hurdle is typically the development of system enhancements that provide timely and accurate information on both the securitized loan pools and the bank's remaining portfolio. Reports should be designed and modified as necessary to allow servicing managers to evaluate the performance of specific loan types and to monitor continuing performance. Quality control of the servicing operation may require periodic reports and an analysis of borrowers' complaints, which are usually about servicing problems or loan quality. The servicer should also have adequate insurance against errors and omissions. The volume and types of loans serviced by the bank will dictate the amount of insurance.

To mitigate transaction risk exposure, pooling and servicing agreements usually require independent accounting reviews of the servicer at least annually. These reviews result in written opinions on the servicer's compliance with the documents and on the adequacy of its operating policies and procedures. Efficient servicers supplement this annual external review of operations with periodic internal reviews.

Servicing capabilities, which should be a subject of long-range technology planning, should keep pace with projected volumes. Plans for servicing should prepare the company to resolve possible incompatibilities of loan systems within the company, as well as incompatibilities of internal systems with pools purchased from third parties. Every bank should have a back-up system, which should be tested at least annually. At a minimum, the guidelines provided in Banking Circular 177, "Corporate Contingency Planning," must be followed.

*Liquidity Enhancement*. In view of the responsibilities and liabilities that may accrue to the servicer as a liquidity provider, a formal policy should be developed that determines how the bank will respond to situations that require funds to be advanced. Servicers who provide back-up liquidity will often protect against exposure to deteriorating asset quality by defining a borrowing base of eligible (performing) assets against which they will advance. They may require that there be no existing breach of covenants or warranties on the loans, and that neither borrowers nor seller have initiated bankruptcy proceedings. Liquidity providers will often have senior liens on the eligible assets, or will otherwise be senior to credit enhancement facilities or other obligations of the issuer.

## Liquidity Risk

Liquidity risk is the risk to earnings or capital arising from a bank's inability to meet its obligations when they come due, without incurring unacceptable losses. Liquidity risk includes the inability to manage unplanned decreases or changes in funding sources. Liquidity risk also arises from the bank's failure to recognize or address changes in market conditions that affect the ability to liquidate assets quickly and with minimal loss in value.

Given adequate planning and an efficient process structure, securitization can provide liquidity for balance sheet assets, as well as funding for leveraging origination capacity. This not only provides banks with a ready source of managed liquidity, but it increases their access to, and presence in, the capital markets.

### Nature of Liquidity Risk

The securitization of assets has significantly broadened the base of funds providers available to banks and created a more liquid balance sheet. Too much reliance on a single funding vehicle, however, increases liquidity risk.

Banks must prepare for the possible return of revolving-credit receivable balances to the balance sheet as a result of either scheduled or early amortization. The primary risk is the potential that large asset pools could require balance sheet funding at unexpected or inopportune times. This risk threatens banks that do not correlate maturities of individual securitized transactions with overall planned balance sheet growth. This exposure is heightened at banks that seek to minimize securitization costs by structuring each transaction at the maturity offering the lowest cost, without regard to maturity concentrations or potential long-term funding requirements.

A second concern is unmitigated dependence on securitization markets to absorb new asset-backed security issues — a mistake that banks originating assets specifically for securitization are more likely to make. Such a bank may allocate only enough capital to support a "flow" of assets to the securitization market. This strategy could cause funding difficulties if circumstances in the markets or at the bank were to force the institution to hold assets on its books.

### Managing Liquidity Risk

The implications of securitization for liquidity should be factored into a bank's day-to-day liquidity management and its contingency planning for liquidity. Each contemplated asset sale should be analyzed for its impact on liquidity both as an individual transaction and as it affects the aggregate funds position.

Liquidity management issues include:

- The volume of securities scheduled to amortize during any particular period;
- The plans for meeting future funding requirements (including when such requirements are expected);
- The existence of early amortization triggers;
- An analysis of alternatives for obtaining substantial amounts of liquidity quickly; and
- Operational concerns associated with reissuing securities.

The bank should monitor all outstanding transactions as part of day-to-day liquidity management. The bank should develop systems to ensure that management is forewarned of impending early amortization triggers, which are often set off by three successive months of negative cash flow (excess spread) on the receivables pool. Management should be alerted well in advance of an approaching trigger so that preventive actions can be considered. Thus forewarned, management should also factor the maturity and potential funding needs of the receivables into shorter-term liquidity planning.

Contingency planning should anticipate potential problems and be thorough enough to assume that, during a security's amortization phase, management will be required to find replacement funding for the full amount of the receivables. Plans should outline various funding alternatives, recognizing that a complete withdrawal from the securitization market or a cutback in lending could affect the bank's reputation with investors and borrowers.

## Compliance Risk

Compliance risk is the risk to earnings or capital arising from violations or nonconformance with laws, rules, regulations, prescribed practices, or ethical standards. Compliance risk also arises in situations where the laws or rules governing certain bank products or activities of the bank's clients may be ambiguous or untested. Compliance risk also exposes the institution to fines, civil money penalties, payment of damages, and the voiding of contracts. Compliance risk can lead to a diminished reputation, reduced franchise value, limited business opportunities, lessened expansion potential, and lack of contract enforceability.

Consumer laws and regulations, including fair lending and other anti-discrimination laws, affect the underwriting and servicing practices of banks even if they originate loans with the intent to securitize them. Management should ensure that staff involved in the underwriting and servicing functions (including collections) comply fully with these laws and regulations. Examiner's should refer to the *Comptroller's Handbook for Compliance* for detailed guidance on identifying and assessing compliance risk in the lending process.

## Other Issues

There are two significant events, effective January 1, 1997, that affect the capital and financial reporting requirements for sales of assets associated with securitization transactions. First, the Federal Financial Institutions Examination Council (FFIEC) decided that banks should follow generally accepted accounting principles (GAAP) for their quarterly reports of condition and income (call reports). Second, The Financial Accounting Standards Board (FASB) adopted Financial Accounting Standard 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" (FAS 125). Both of these changes affect how banks must recognize revenue and maintain capital for securitization transactions.

### Accounting

Under GAAP, the applicable accounting guidance for asset transfers in a securitization transaction is FAS 125. Although primarily concerned with differentiating sales from financing treatment, FAS 125 also describes how to properly account for servicing assets and other liabilities in securitization transactions. FAS 125 applies to all types of securitized assets, including auto loans, mortgages, credit card loans, and small business loans. FAS 125 replaced previous accounting guidance including FAS 77, "Reporting by Transferor for Transfers of Receivables with Recourse," FAS 122, "Accounting for Mortgage Servicing Rights," and various guidance issued by FASB's Emerging Issues Task Force.

Generally, the accounting treatment for an asset transfer under FAS 125 is determined by whether legal control over the financial assets changes. Specifically, a securitization transaction will qualify for "sales" treatment (i.e., removal from the seller's reported financial statements) if the transaction meets the following conditions:

- The transferred assets are isolated from the seller (that is, they are beyond the reach of the seller and its creditors, even in bankruptcy or other receivership);

- The buyer can pledge or exchange the transferred assets, or the buyer is a qualifying special-purpose entity and the holders of the beneficial interests in that entity have the right to pledge or exchange those interests; and

- The seller does not retain effective control over the transferred assets through an agreement that

    - Both entitles and obligates it to repurchase the assets before maturity, or
    - Entitles it to repurchase transferred assets that are not readily obtainable in the market.

If the securitization transaction meets the FAS 125 criteria, the seller:

- Removes all transferred assets from the balance sheet;
- Recognizes all assets obtained and liabilities incurred in the transaction at fair value; and
- Recognizes in earnings any gain or loss on the sale.

Any recourse obligation in a transaction qualifying for sales treatment should be recorded as a liability, at fair value, and subtracted from the cash received to determine the gain or loss on the transaction. If the "sales treatment" criteria are not met, the transferred assets remain on the balance sheet and the transaction is accounted for as a secured borrowing (and no gain or loss is recognized).

*A Sample Transaction.* The adoption of GAAP for regulatory reporting purposes and FAS 125 change the accounting for asset sales associated with securitization transactions. Certain gains or losses that were deferred under previous regulatory accounting practices are now recognized on the sale date.

The following is an *example* of the accounting entries a seller might make when transferring credit card receivables to a master trust:

**The initial sales transaction:**

| | |
|---|---|
| Principal amount of initial receivables pool: | $120,000 |
| Carrying amount net of specifically allocated loss reserve | $117,000 |
| Servicing fee (based on outstanding receivables balance) | 2% |
| Up-front transaction costs: | $ 600 |
| Seller's interest: | $ 20,000 |
| Value of servicing asset | $ 1,500 |

**Transaction structure**

| | Fair Value* | Allocated % of total Fair Value | Carrying Amount | Portion Sold | Portion Retained |
|---|---|---|---|---|---|
| Class A | $ 100,000 | (117/124.5) | $ 93,976 | $ 93,976 | |
| Seller's Interest | $ 20,000 | (117/124.5) | $ 18,795 | | $ 18,795 |
| IO Strip** | $ 3,000 | (117/124.5) | $ 2,819 | | $ 2,819 |
| Servicing | $ 1,500 | (117/124.5) | $ 1,410 | | $ 1,410 |
| Total | $124,500 | | $117,000 | $ 93,796 | $ 23,024 |

**Must be estimated. See guidance under "Estimating Fair Value."*

***An IO (interest-only) strip is a contractual right to receive some or all of the interest due on an interest bearing financial instrument. In a securitization transaction, it refers to the present value of the expected future excess spread from the underlying asset pool.*

The journal entries to record the initial transaction on the books of the bank are:

| | | Debits | |
|---|---|---|---|
| Entry #1. | Cash | $99,400 | ($100,000 - 600) |
| | IO Strip | 2,819 | |
| | Servicing Asset | 1,410 | |
| | Seller's Certificate | 18,795 | |

| | Credits |
|---|---|
| Net Carrying Amount of Loans | $117,000 |
| Pretax Gain | 5,424 |

(To record securitization transaction by recognizing assets retained and by removing assets sold.)

FAS 125 requires the seller to record the IO strip at its allocated cost. However, since the IO strip is treated like a marketable equity security, it must be carried at fair market value throughout its life. Therefore, adjusting entries are necessary if the asset's estimated value changes. The following journal entry represents the recognition of an increase in the fair value of the asset. (The reverse of this entry would occur if the periodic estimate found that the value had declined or been impaired.)

| | | | Debits | Credits |
|---|---|---|---|---|
| Entry #2. | IO Strip | | $181 | |
| | | Equity | | $181 |

(To measure an IO strip categorized as an available-for-sale security at its fair market value as required under FAS 115).

As the bank receives cash associated with excess spread from the trust, the effect of the journal entries is to increase cash and reduce the amount of the IO strip. In effect, the entry would be:

| | | | Debits | Credits |
|---|---|---|---|---|
| Entry #3. | Cash | | $10 | |
| | | IO Strip | | $10 |

(To recognize cash "excess spread" from the trust.)

If the transaction meets the FAS 125 sales criteria, a selling bank should recognize the servicing obligation (asset or liability) and any residual interests in the securitized loans retained (such as the IO strip and the seller's certificate). The bank should also recognize as assets or liabilities any written or purchased options (such as recourse obligations), forward commitments, or other derivatives (e.g., commitments to deliver additional receivables during the revolving period of a securitization), or any other rights or obligations resulting from the transaction.

*Estimating Fair Value.* FAS 125 guidance states that the fair value of an asset (or liability) is the amount for which it could be bought or sold in a current transaction between willing parties — that is, in other than a forced liquidation sale. Quoted market prices in active markets are the best evidence of fair value and, if available, shall be used as the basis for the pricing.

Unfortunately, it is unlikely that a securitizer will find quoted market prices for most of the financial assets and liabilities that arise in a securitization transaction. Accordingly, estimation is necessary. FAS 125 says that if quoted market prices are not available, the estimate of fair value shall be based on the best information available. Such information includes prices for similar assets and liabilities and the results of valuation techniques such as:

- The present value of estimated expected future cash flows using a discount rate commensurate with the risks involved;
- Option-pricing models;
- Matrix pricing;
- Option-adjusted spread models; and
- Fundamental analysis.

These techniques should include the assumptions about interest rates, default rates, prepayment rates, and volatility that other market participants employ in estimating value. Estimates of expected future cash flows should be based on reasonable and supportable assumptions and projections. All available evidence should be considered in developing estimates of expected future cash flows. The weight given to the evidence should be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of future cash flows, the likelihood of possible outcomes should be considered to determine the best estimate.

*Recognition of Servicing.* A servicing asset should be recorded if the contractual servicing fee more than adequately compensates the servicer. (Adequate compensation is the amount of income that would fairly compensate a substitute servicer, and includes the profit that would be required in the market place.) The value of servicing assets includes the contractually specified servicing fees, late charges, and other related fees and income, including float.

A servicing liability should be recorded when the estimated future revenues from stated servicing fees, late charges, and other ancillary revenues are not expected to adequately compensate the servicer for performing the servicing.

The recorded value of servicing rights is initially based on the fair value of the servicing asset relative to the total fair value of the transferred assets. Servicing assets must be amortized in proportion to estimated net servicing income and over the period that such income is received. In addition, servicing assets must be periodically evaluated and measured for impairment. Any impairment losses should be recognized in current period income.

According to FAS 125, servicing assets should be subsequently measured and evaluated for impairment as follows:

1. Stratify servicing assets based on one or more of their predominant risk characteristics. The risk characteristics may include financial asset type, size, interest rate, date of origination, term, and geographic location.

2. Recognize impairment through a valuation allowance for each individual stratum. Impairment should be recognized as the amount by which the carrying amount of a category of servicing assets exceeds its fair value. The fair value of servicing assets that have not been recognized should not be used in this evaluation.

3. Periodically adjust the valuation allowance to reflect changes in impairment. However, appreciation in the fair value of a stratum of servicing assets over its carrying amount should not be recognized.

*Treatment of Excess Cash Flows*. The right to future income in excess of contractually stated servicing fees should be accounted for separately from the servicing asset. The right to these cash flows is treated as an interest-only strip and accounted for under FAS 115 as either an available-for-sale or trading security.

If IO strips or other receivables or retained interests in securitizations can be contractually prepaid or settled in a way that the holder might not substantially recover its recorded investment, FAS 125 requires that they be measured at fair value and that the treatment be similar to that given available-for-sale and trading securities under FAS 115. Accordingly, these items are initially recorded at allocated fair value. (Allocating fair value refers to apportioning the previous carrying amount of the transferred assets between the assets sold and the interests retained by the seller based on their relative fair values at the date of transfer. See example entry #1.) These items are periodically adjusted to their estimated fair value (example entry #2) based on their expected cash flows.

*Recognition of Fees.* The accounting treatment of fees associated with loans that will be securitized should be in accordance with FAS 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases" and FAS 65, "Accounting for Certain Mortgage Banking Enterprises." In accordance with these statements' standards for pools of loans that are held for sale, the loan origination fees and direct loan origination costs should be deferred and recognized in income when the loans are sold.

## Risk-Based Capital[4]

### Asset Sales without Recourse

Securitization can have important implications for a bank's risk-based capital requirement. (For a more complete discussion of OCC risk-based capital requirements, see the "Capital and Dividends" section of the *Comptroller's Handbook*.) If asset sales meet the "sale" requirements of FAS 125 and the assets are sold without recourse, the risk-based capital standards do not require the seller to maintain capital for the assets securitized. The primary attraction of securitization for bank issuers (notwithstanding the wealth of liquidity inherent in selling loans quickly and efficiently for cash) is the ability to avoid capital requirements while realizing considerable financial benefits (e.g., servicing fees, excess servicing income, and origination fees). Several of the "pure play" or monoline banks have off-balance-sheet, securitized assets that are several times larger than their on-balance-sheet loan amounts.

Although the risk-based capital standards are heavily weighted toward credit risk, a bank's capital base must also be available to absorb losses from other types of risk, such as funding source concentrations, operations, and liquidity risk. For this reason, it is prudent for banks to evaluate all of the exposures associated with securitizing assets, especially revolving assets such as credit cards and home equity lines of credit for which the bank retains a close association with the borrower even after a specific receivable balance has been sold.

Using models or other methods of analysis, a bank should allocate the appropriate amount of capital to support these risks. At least two major off-balance-sheet risk areas pertinent to securitization are not specifically discussed in the minimum capital requirements of risk-based capital:

- Servicing obligations.
- Liquidity risk associated with revolving asset pools.

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4 At the time of this writing there are a number of pending regulations that affect capital (servicing assets, recourse, small business recourse, etc.). The reader should refer to 12 CFR 3 and "Instructions for the Consolidated Reports of Condition and Income" for definitive capital regulations and guidance.

*Servicing Obligations.* Securitization is a volume business that rewards economies of scale. The amount of capital support should be commensurate with the expected transaction volumes, the nature of the transactions (revolving or amortizing), the technology requirements, and the complexity of the collections process. A bank should consider increasing capital for servicing if bank personnel are not experienced with the asset and borrower types anticipated, the bank is offering a new product or entering a new business line, or the complexity of the servicing is growing.

*Liquidity Risks.* Securitization transactions involving revolving assets (for example, credit cards and home equity lines of credit) pose more liquidity risk than amortizing assets such as automobile loans. When a revolving-asset securitization matures, the bank must either roll any new receivables into another securitization or find another way to fund the assets. While most banks will not find it difficult to access the securitization markets in normal times, the risk of overall market disruption does exist. In addition, if a bank's financial condition or capacity to provide servicing deteriorates, access to the markets may be limited or using them may not be cost effective. These possibilities should be reflected in determining capital adequacy.

*Other Factors.* Other factors not related to credit may expose a bank to additional risk, such as representations and warranties provided by the seller, and some kinds of obligations associated with acting as a trustee or advisor for a transaction. These may vary with specific transactions and should be included in any analysis of capital adequacy.

*Capital Reserves.* When an issuer securitizes receivables, it usually reverses the bad debt reserves previously held against the receivables and takes that amount into income. Often, at the time of sale, issuers will use these freed-up reserves to set up new capital reserves for potential exposures associated with securitization transactions. While these new reserves are a healthy recognition that all risk exposures are not eliminated when assets are securitized, the capital allocation for exposures to off-balance-sheet securitization transactions should specifically reflect the nature and volume of the remaining exposures. These transaction, liquidity, and other risks may not be identical to the credit risk that has been transferred, and the capital analysis and resulting reserve decisions should focus on actual risk exposure.

## Asset Sales with Recourse

Generally, the risk-based capital requirements for assets transferred with recourse were not changed by the adoption of GAAP for regulatory reporting purposes on January 1, 1997. Guidance for the accounting and risk-based capital treatment of asset sales with recourse can be found in 12 CFR 3, appendix A, section 3(b)(1)(B)(iii), with accompanying footnote; in the instructions for the preparation of the consolidated reports of condition and income (the call reports); and in periodic interpretive letters issued by the regulatory agencies. These guidelines address the determination of recourse in an asset sale, the associated risk-based capital requirements, and the treatment of limited, or "low-level," recourse transactions.

*Recourse Determination.* In securitization activities, "recourse" typically refers to the risk of loss that a bank retains when it sells assets to a trust or other special-purpose entity established to issue asset-backed securities. The general rule is that a transfer that qualifies for sales treatment under GAAP does not require risk-based capital support provided the transferring bank:

1. Does not retain risk of loss on the transferred assets from any source, and

2. Is not obligated to any party for the payment of principal or interest on the assets transferred resulting from:

    a. Default on principal or interest by the obligor of the underlying instrument or from any other deficiencies in the obligor's performance.

    b. Changes in the market value of the assets after they have been transferred.

    c. Any contractual relationship between the seller and purchaser incident to the transfer that, by its term, could continue after final payment, default, or other termination of the assets transferred.

    d. Any other cause.

If risk or obligation for payment of principal or interest is retained by, or may revert to, the seller in an asset transfer that qualifies for sale treatment under GAAP, the transaction *must* be considered an "asset sale with recourse" for risk-based capital purposes.

Two exceptions to the general recourse rule do not by themselves cause a transaction to be treated as a sale with recourse. These exceptions are contractual provisions that:

- Provide for the return of the assets to the seller in instances of incomplete documentation or fraud.

- Allow the purchaser a specific period of time to determine that the assets transferred are as represented by the seller and to return deficient paper to the seller.

Assets transferred in transactions that do not qualify as sales under GAAP should continue to be reported as assets on the call report balance sheet and are subject to regulatory capital requirements.

Most transactions that involve recourse are governed by contracts written at the time of sale. These contracts set forth the terms and conditions under which the purchaser may compel payment from the seller. In some instances of recourse a bank assumes risk of loss without an explicit contractual agreement or in amounts exceeding a specified contractual limit. A bank suggests that it may have granted *implicit* recourse by taking certain actions subsequent to the sale. Such actions include: a) providing voluntary support for a securitization by selling assets to a trust at a discount from book value; b) exchanging performing for nonperforming assets; c) infusing additional cash into a spread account or other collateral account; or d) supporting an asset sale in other ways that impair the bank's capital. Proving the existence of implicit recourse is often a complex and fact-specific process. Therefore, the OCC expects that the general test of loss retention and capital impairment, supplemented by periodic interpretations as structures and asset-types evolve, will be the most effective method of determining the existence of recourse in securitization transactions.

*Risk-Based Capital Treatment.* Asset sales with recourse are reported on the call report in Schedule RC-L, "Off-Balance-Sheet Items," and Schedule RC-R, "Regulatory Capital." Under the risk-based capital standards, assets sold with recourse are risk-weighted using two steps. First, the full outstanding amount of assets sold with recourse is converted to an on-balance-sheet credit equivalent amount using a 100 percent credit conversion factor, except for certain low-level recourse transactions (described below) and small business obligations transferred with recourse. Second, the credit equivalent amount is assigned to the appropriate risk-weight category according to the obligor or, if relevant, the guarantor or the nature of the collateral.

*Low-Level Recourse Transactions*. According to the risk-based capital standards, the amount of risk-based capital that must be maintained for assets transferred with recourse should not exceed the maximum amount of recourse for which a bank is contractually liable under the recourse agreement. This rule applies to transactions in which a bank contractually limits its risk of loss or recourse exposure to less than the full effective minimum risk-based capital requirement for the assets transferred. The low-level recourse provisions may apply to securitization transactions that use contractual cash flows (e.g., interest-only strips receivable and spread accounts), retained subordinated interests, or retained securities (e.g., collateral invested amounts and cash collateral accounts) as credit enhancements. If the low-level recourse rule applies to these credit enhancements, the maximum contractual dollar amount of the bank's recourse exposure, and therefore that amount of risk-based capital that must be maintained, is generally limited to the amount carried as an asset on the balance sheet in accordance with GAAP. The call report instructions for Schedule RC-R provide specific guidance for the reporting and capital requirements for low-level recourse transactions.

1. To determine the quantity of risk and the quality of risk management by assessing whether the bank is properly identifying, measuring, monitoring, and controlling the risks associated with its securitization activities.

2. To determine whether the bank's strategic or business plan for asset securitization adequately addresses resource needs, capital requirements, and profitability objectives.

3. To determine whether asset securitization policies, practices, procedures, objectives, internal controls, and audit functions are adequate.

4. To determine that securitization activities are properly managed within the context of the bank's overall risk management process.

5. To determine the quality of operations and the adequacy of MIS.

6. To determine compliance with applicable laws, rulings, regulations, and accounting practices.

7. To determine the level of risk exposure presented by asset securitization activities and evaluate that exposure's impact on the overall financial condition of the bank, including the impact on capital requirements and financial performance.

8. To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient, or when violations of law, rulings, or regulations have been noted.

Many of the steps in these procedures require examiners to gather information from or review information with examiners in other areas, particularly those responsible for originating assets used in securitized pools (e.g., retail lending, mortgage banking, credit card lending). To avoid duplicating examination procedures already being performed in these areas, examiners should discuss and share examination data related to asset securitization with examiners from these other areas before beginning these procedures.

Examiners should cross-reference information obtained from other areas in their examination work papers. When information is not available from other examiners, it should be requested directly from the bank. The final decision on the scope of the examination and the most appropriate way to obtain information rests with the examiner-in-charge (EIC).

The examination procedures in the first section ("Overview") will help the examiner determine how the bank securitizes and the general level of management and board oversight. The procedures in the second section ("Functions") supplement the "Overview" section and will typically be used for more in-depth reviews of operational areas. The procedures in "Overall Conclusions" (#s 67-71) should be completed for each examination.

## Overview

1. Obtain and review the following documents:

   - ☐ Previous examination findings related to asset securitization and management's response to those findings.
   - ☐ Most recent risk assessment profile of the bank.
   - ☐ Most recent internal/external audits addressing asset securitization and management's response to significant deficiencies.
   - ☐ Supervisory Monitoring System (SMS) reports.
   - ☐ Scope memorandum issued by the bank EIC.

☐ Strategic or business plan for asset securitization.

☐ All written policies or procedures related to asset securitization.

☐ A description of the risk measurement and monitoring system for securitization activities and a copy of all related MIS reports. (Measurement systems may include tracking reports, exposure reports, valuation reports, and profitability analyses. See the examination procedures under "Management Information Systems" for additional details.)

☐ A summary or outline of all outstanding asset-backed issuances. Document for the permanent work paper file information for each outstanding security including:

- The origination date, original deal amount, current outstanding balance, legal maturity, expected maturity, maturity type (hard bullet, soft bullet, controlled `amortization, etc.), revolving period dates, current coupon rates, gross yield, loss rate, base rate, excess spread amounts (one month and three month), monthly payment rates, and the existence of any interest rate caps.
- The amount and form of credit enhancements (over-collateralization, cash collateral accounts, spread accounts, etc.).
- Performance triggers relating to early amortization events or credit enhancement levels.

☐ Copies of pooling and servicing agreements and/or series supplements for major asset types securitized or those targeted at this exam.

☐ Information detailing the potential contractual or contingent liability from guarantees, underwriting, and servicing of securitized assets.

☐ Copies of compensation programs, including incentive plans, for personnel involved in securitization activities.

☐ Current organizational chart for the asset securitization unit of the bank.

☐ A list of board and executive or senior management committees that supervise the asset securitization function, including a list of members and meeting schedules. Also, minutes documenting meetings held since the last examination should be available for review.

2. Determine whether any material changes have occurred since the last review regarding originations and purchases, servicing, or managing securitized portfolios.

3. Based on results from the previous steps and discussions with the bank EIC and other appropriate supervisors, determine the scope and objectives of the examination.

**Select from among the following examination procedures the steps necessary to meet examination objectives. Examiners should tailor the procedures to the specific activities and risks faced by the bank. Note: Examinations will seldom require completion of all steps.**

4. As examination procedures are performed, test for compliance with established policies and confirm the existence of appropriate internal controls. Identify any area that has inadequate supervision or poses undue risk, and discuss the need to perform additional or expanded procedures with the EIC.

## Management Oversight

5. Review the bank's securitization business plan. Determine that it has been reviewed by all significant affected parties and approved by the bank's board of directors. At a minimum, the plan should address the following:

   a. The integration of the securitization program into the bank's corporate strategic plan.

   b. The integration of the securitization program into the bank's asset/liability, contingency funding, and capital plans.

   c. The integration of the securitization program into the bank's compliance review, loan review, and audit program.

   d. The specific capacities in which the bank will engage (servicer, trustee, credit enhancer, etc.).

e. The establishment of a risk identification process.

f. The type(s) and volume of business to be done in total (aggregate of deals in process as well as completed deals that are still outstanding).

g. Profitability objectives.

6. Evaluate the quality of the business plan. Consider whether:

a. The plan is reasonable and achievable in light of the bank's capital position, physical facilities, data processing systems capabilities, size and expertise of staff, market conditions, competition, and current economic forecasts.

b. The feasibility analysis considers tax, legal, and resource implications.

c. The goals and objectives of the securitization program are compatible with the overall business plan of the bank, the holding company, or both.

7. Determine whether the bank has and is following adequate policies and operating procedures for securitization activities. At a minimum, policies should address:

a. Permissible securitization activities including individual responsibilities, limits, and segregation of duties.

b. Authority levels and responsibility designations covering:

- Transaction approvals and cancellations;
- Counterparty approvals for all outside entities the bank is doing business with (originators, servicers, packagers, trustees, credit enhancers, underwriters, and investors);
- Systemic and individual transaction monitoring;
- Pricing approvals;
- Hedging and other pre-sale decisions;

- Quality standard approvals; and
- Supervisory responsibilities over personnel.

c. Exposure limits by:

- Type of transaction;
- Individual transaction dollar size;
- Aggregate transactions outstanding (because of the moral recourse implicit in the bank's name on the securities);
- Geographic concentrations of transactions (individually and in aggregate);
- Maturities of transactions (particularly important in evergreen deals, i.e., credit cards and home equity lines); and
- Originators (for purchased assets), credit enhancers, trustees, and servicers.

d. Quality standards for all transactions in which the bank plans to participate. Standards should extend to all counterparties conducting business with the bank.

e. Minimum MIS reports to be presented to senior management and the board or appropriate committees. (During reviews of applicable meeting minutes, ascertain which reports are presented and the depth of discussions held).

8. Review the organizational structure and determine who is responsible for coordinating securitization activities.

a. Determine whether the board of directors or appropriate committee and management have a separate securitization steering committee. If so, review committee minutes for significant information.

b. Determine whether decision making is centralized or delegated.

c. Determine which individuals are responsible for major decisions and where final decisions are made.

9. Determine whether, before approving a new securitization transaction, the bank requires sign-off from the following departments:

   - Appropriate credit division
   - Treasury or capital markets
   - Audit
   - Asset and liability management
   - Capital planning committee
   - Legal
   - Liquidity management
   - Operations

10. Assess the expertise and experience of management responsible for securitization activities.

    a. Conduct interviews and review personnel files and resumes to determine whether management and other key staff members possess appropriate experience or technical training to perform their assigned functions.

    b. Review management succession plans and determine whether designated successors have the necessary background and experience.

11. Review incentive plans covering personnel involved in the securitization process. Determine whether plans are oriented toward quality execution and long-run profitability rather than high-volume, short-term asset production and sales.

    a. Ensure that such plans have been approved by the board of directors or an appropriate committee.

    b. Determine that senior management and the board of directors are aware of any substantial payments or bonuses made under these plans.

12. Evaluate the pricing system used in all aspects of securitization.

    a. Determine that the bank has a system for quantifying costs and risks (liquidity, credit, transaction, etc.) and for making incremental adjustments to compensate for the less readily quantifiable costs and risks.

    b. Determine whether decision makers use an effective pricing system to determine whether prospective transactions will be profitable.

## Risk Management

13. Determine whether the risk management process is effective and based on timely and accurate information. Evaluate its adequacy in managing significant risks in each area of the securitization process.

    a. Ascertain whether management has identified all significant risks in each of the bank's planned roles.

    b. Determine how these risks are monitored and controlled.

    c. Evaluate how controls are integrated into overall bank systems.

    d. Evaluate management's method of allocating capital or reserves to various business units in recognition of securitization risks.

14. Determine that the bank's obligations from securitization activities have been reviewed by appropriate legal counsel.

    a. Ensure that legal counsel has reviewed and approved any standardized documents used in the securitization process. Counsel should also review any transactions that deviate significantly from standardized documents.

    b. If the bank is involved in issuing prospectuses or private placement memoranda, ensure that legal counsel has reviewed them. Also, ensure that operating practices require a party independent of the securitization process to check the financial and statistical information in the prospectus for accuracy.

15. Determine that the scope of credit and compliance reviews includes loans originated for securitization or purchased for that purpose.

    a. Ascertain appropriateness of scope, frequency, independence, and competency of reviews in view of the bank's activity volume and risk exposure.

    b. Credit and compliance reviews should include:

        - Loans on the bank's books and not yet securitized;
        - Loans in process of being securitized; and
        - Completed deals that bear the bank's name or in which the bank has ongoing responsibilities (servicer, trustee, etc.).

**Portfolio Management**

16. Determine whether management's assessment of the quality of loan origination and credit risk management includes *all* managed assets (receivables in securitization programs and on-balance-sheet assets). At a minimum, the assessment should include:

    a. A review of the number and dollar volume of existing past-due loans, early payment defaults, and repurchased loans from securitized asset pools. The review should also compare the bank's performance to industry, peer group averages, or both.

    b. An analysis of the cause of delinquencies and repurchases.

    c. The impact on delinquencies and losses of altered underwriting practices, new origination sources, and new products.

    d. Determination of whether repurchases or other workout actions compromised the sales status of problem credits or related assets.

17. Determine whether the bank performs periodic stress tests of securitized asset pools. Determine whether these tests:

    a. Consider the appropriate variables affecting performance according to asset or pool type.

    b. Are conducted well in advance of approaching designated early amortization triggers.

    c. Are adequately documented.

18. If third parties provide credit or liquidity enhancements for bank-sponsored asset-backed securities, determine whether their credit rating has been downgraded recently or whether their credit quality has deteriorated. If so, determine what actions the bank has taken to mitigate the impact of these events.

19. Assess whether securitization activities have been adequately integrated into liquidity planning. Consider whether:

    a. The cash flows from scheduled maturities of revolving asset-backed securities are coordinated to minimize potential liquidity concerns.

    b. The impact of unexpected funding requirements due to early amortization events are factored into contingency funding plans for liquidity.

**Internal and External Audit**

20. Review the bank's internal audit program for securitization activities. Determine whether it includes objectives, written procedures, an audit schedule, and reporting systems that are appropriate in view of the bank's volume of activity and risk exposure.

    a. Review the education, experience, and ongoing training of the internal audit staff and evaluate its expertise in auditing securitization activities.

b. Determine whether comprehensive audits of all securitization areas are conducted in a timely manner. Ensure that the scope of internal audit includes:

- An evaluation of compliance with pooling and servicing agreement requirements; and
- Periodic verification of the accuracy of both internal and external portfolio performance reports.

c. Review management's responses to audit reports for timeliness and implementation of corrective action when appropriate.

21. If the external auditors review the major operational areas involved in securitization activities, review the most recent engagement letter, external audit report, and management letter. Determine:

a. To what extent the external auditors rely on the internal audit staff and the internal audit report.

b. Whether the external auditors rendered an opinion on the effectiveness of internal controls for the major products or services related to securitization.

c. Whether management promptly and effectively responds to the external auditor's concerns and recommendations. Assess whether management makes changes to operating and administrative procedures that are appropriate responses to report findings.

## Management Information Systems

22. Review management information systems to determine whether they provide appropriate information for monitoring securitization activities.

a. Evaluate reports produced for each capacity in which the bank is involved. At a minimum, the following should be produced:

- Tracking reports to monitor overall securitization activity. Reports should include:

- Completed transactions, transactions in process, and prospective transactions;
- Exposure reports detailing exposures by specific function (credit enhancer, servicer, trustee, etc.) and by counterparties; and
- Profitability analysis by product and functional department (originations, servicing, trustees, etc.). Profitability reports should include cost-center balance sheet and earnings statements. The balance sheets should reflect the amount of capital and reserves set aside for risks within the various functions.

• Inventory reports to monitor available transaction collateral. Reports should include summaries by:

  - Product type, including outstanding and committed receivable amounts;
  - Geographic or other types of concentrations; and
  - Sale status (for transactions in process).

• Performance reports by portfolio and specific product type. Reports should reflect performance of both assets in securitized pools and total managed assets. Reports should include:

  - Credit quality (delinquencies, losses, portfolio aging, etc.);
  - Profitability (by individual transaction and product type); and
  - Performance compared with expected performance (portfolio yields, monthly principal payment rates, purchase rates, charge-offs, etc.).

b. Determine whether MIS provides sufficient detail to permit reviews for compliance with policy limits and to make appropriate disclosures on regulatory reports and other required financial statements. Evaluate whether:

- The frequency of report generation is commensurate with volume and risk exposure; and
- Reports are distributed to, and reviewed by, appropriate management, board committees, or both.

23. Determine whether investor reporting is accurate and timely. Choose a sample of outstanding transactions and compare internal performance reports with those provided to investors. Note: Examiners can supplement this procedure by comparing internal reports with information reported by external sources (such as Bloomberg, Fitch, and Moody's). Discrepancies should be brought to management's attention immediately.

## Accounting and Risk-Based Capital

24. Determine whether the bank is classifying securitization transactions appropriately as "sales" or "financings."

    a. Determine that the bank has a system to ensure that independent personnel review transactions and concur with accounting treatment.

    b. Ensure that audit has tested for proper accounting treatment as part of its normal reviews.

25. For transactions that qualify for sales treatment under FAS 125, review the written policies and procedures to determine whether they:

    a. Allocate the previous book carrying amount between the assets sold and the retained interests based on their fair market values on the date of transfer.

    b. Adjust the net proceeds received in the exchange by recording, on the balance sheet, the fair market value of any guarantees, recourse obligations, or derivatives such as put options, forward commitments, interest rate swaps, or currency swaps.

    c. Recognize gain or loss only on assets sold.

d. Continue to carry on the balance sheet any retained interest in the transferred assets. Such balance sheet items should include servicing assets, beneficial debt or equity interests in the special-purpose entity, or retained undivided interests.

26. Determine whether the asset values and periodic impairment analyses for servicing assets and rights to future excess interest (IO strips) are consistent with FAS 125 and regulatory accounting requirements.

a. Determine whether the bank has a reasonable method for determining fair market value of the assets.

b. Determine whether recorded servicing and IO strip asset values are reviewed in a timely manner and adjusted for changes in market conditions.

For servicing assets, verify that:

- Servicing assets are appropriately stratified by predominant risk characteristics (e.g., asset type, interest rate, date of origination, or geographic location);
- Impairment is recognized by stratum;
- Impairment is assessed frequently (e.g., at least quarterly);
- Assumptions and calculations are documented; and
- Servicing assets are not recorded at a value greater than their original allocated cost.

For IO strip assets, verify that:

- Valuation considers changes in expected cash flows due to current and projected volatility of interest rates, default rates, and prepayment rates; and
- IO strips are recorded at fair market value consistent with available-for-sale or trading securities.

c. Determine that servicing assets and IO strips are accorded appropriate risk-based capital treatment. Ensure that:

- Nonmortgage servicing assets are fully deducted from Tier 1 capital and risk-weighted assets. (Mortgage-related servicing assets and purchased credit card relationships may be included in Tier 1 capital; however, the total of all mortgage related servicing assets and purchased credit card relationships is limited. See 12 CFR 3 and related interpretations.)
- Risk-based capital is allocated for the lower of the full amount of the assets transferred or the amount of the IO strip, consistent with low-level recourse rules.

27. For revolving trusts, review procedures for accounting for new sales of receivables to the trust.

    a. Verify that accrued interest on receivables sold is accounted for properly.

    b. Determine whether gain or loss is properly booked.

28. Determine whether the bank maintains capital reserves for securitized assets. Determine whether the method for calculating the reserves is reasonable. Consider:

    a. The volume and nature of servicing obligations.

    b. The potential impact on liquidity of revolving-asset pools.

    c. Other potential exposures.

**Recourse Transactions**

29. Determine whether the bank transfers loans with recourse. If so, determine whether:

    a. Written policies guide management with respect to the type and amount of recourse it can offer. Such policies should address:

       - Full or partial recourse specified in the servicing contract;

- Warranties and representations in the sale of loans, including warranties against noncompliance with consumer laws and regulations;
- Repurchase agreements in case of early default or early prepayment of securitized loans;
- Spread accounts or cash reserves;
- Vested business relationships with purchasers of whole loans or investors in asset-backed securities; and
- Environmental hazards.

b. Adequate management information systems exist to track all recourse obligations.

c. Asset sales with recourse, including low-level transactions, are reported appropriately in schedule RC-R of the report of condition and income (call report).

d. If recourse is limited, determine whether the bank's systems prevent it from making payments greater than its contractual obligation to purchasers.

30. Determine whether the bank has developed written standards for refinancing, renewing, or restructuring loans previously sold in asset-backed securities transactions. Determine whether:

a. The standards distinguish a borrower's valid desire to reduce an interest rate through renewal, refinancing, or restructuring designed to salvage weak credits.

b. The standards prevent the bank from repurchasing distressed loans from the securitized credit pool and disguising their delinquency in the bank's loan portfolio.

## Functions

The following guidelines supplement the procedures in the “Overview” section. These procedures will often be performed by product (loan) type and should be coordinated with other examination areas to avoid duplication of effort.

### Originations

31. Determine whether senior management or the board is directly involved in decisions concerning the quality and types of assets that are to be securitized as well as those to be retained on the balance sheet. Ensure that written policies:

    a. Outline objectives relating to securitization activities.

    b. Establish limits or guidelines for:

    - Quality of loans originated
    - Maturity of loans originated
    - Geographic dispersion of loans
    - Acceptable range of loan yields
    - Credit quality
    - Acceptable types of collateral
    - Types of loans

32. Determine whether the credit standards for loans to be securitized are the same as the ones for loans to be retained.

    a. If not, ascertain whether management consciously made this decision and that it is clearly stated in the securitization business plan.

    b. If higher quality loans are to be securitized in order to gain initial market acceptance, determine whether the bank limits the amount of lower quality assets it originates or retains. Also, determine whether the allowance for loan and lease losses and capital are adjusted for the higher proportion of risk in total assets.

c. Determine whether there are sufficient administrative and collection personnel on hand to properly administer and collect lower quality credits.

33. Ensure that there is a complete separation of duties between the credit approval process and loan sales/securitization effort. Determine whether lending personnel are solely responsible for:

    a. The granting or denial of credit to customers.

    b. Credit approvals of resale counterparties.

34. Ensure that loans to be sold or securitized are segregated or otherwise identified on the books of the originating bank. Also, determine that the bank is following appropriate accounting standards regarding market valuation procedures on assets held for sale.

35. If loans are granted or denied based on a credit scoring system, ascertain whether the system was developed based on empirically derived data. Ensure that it is periodically revalidated.

36. Determine whether the bank is making efforts to ensure that the customer base is not suffering from economic redlining. If economic redlining is occurring, determine what actions the bank is taking to counteract these effects. (Evidence of redlining should be immediately discussed with the EIC and/or appropriate compliance examiner.)

37. Determine whether written policies address borrower's expectations of confidentiality and rights to financial privacy by requiring:

    a. The opinion of counsel on what matters may be disclosed.

    b. Written notice (when counsel deems it necessary) that loans may be sold in whole or pledged as collateral for asset-backed securities and that certain confidential credit information may be disclosed to other parties.

    c. When necessary, the borrower's written waiver of confidentiality.

**Purchased Loans**

38. Determine whether the bank has written procedures on acquiring portfolios for possible securitization. If so, determine whether the procedures are adequate given the volume and complexity of the potential purchases.

39. Evaluate management's method of determining whether prospective asset purchases meet the quality standards represented by the seller. Ensure that the process considers whether purchased assets are compatible with the bank's data systems, administration and collection systems, credit review talent, and compliance standards, particularly consumer protection laws.

40. If the bank has recently purchased a portfolio for use in a securitization transaction, review the due diligence work papers to assess their adequacy and compliance with policy.

41. Determine whether the bank conducts postmortem reviews on acquired portfolios, and, if so, what procedures are used. Identify who receives the results and whether appropriate follow-up action is taken (changes in quality standards, due diligence procedures, etc.)

42. Ensure that operating systems segregate or otherwise identify loans being held for resale. Review accounting practices to ensure appropriate treatment of assets held for resale.

43. Evaluate the measures taken to control pipeline exposure.

    a. If pre-sales are routine, determine whether credit approval and diversification standards for purchasers are administered by people who are independent of the asset purchasing and packaging processes.

    b. Evaluate the reasonableness of limits on inventory positions that are not pre-sold or hedged.

c. If assets held for resale are required to be hedged, ensure that controls over hedging include:

- An approved list of hedging instruments;
- Minimum acceptable correlation between the assets held for sale and the hedging vehicle;
- Maximum exposure limits to unhedged loan commitments under various interest rate simulations;
- Credit limits on forward sale exposure to a single counterparty;
- A prohibition against speculation; and
- Acceptable reporting systems for hedging transactions.

## Servicing

44. Determine whether written policies are in place for servicing activities that:

    a. Outline objectives for the servicing department.

    b. List the types of loans that the bank is permitted to service.

    c. Specify procedures for valuing retained and purchased servicing rights.

    d. Require legal counsel to review each transaction for conflicts of interest when the bank serves in multiple capacities such as:

    - Originator
    - Servicer
    - Trustee
    - Credit enhancer
    - Market maker
    - Lender in other relationships to borrowers, investors, originators
    - Investor

45. Determine whether MIS reports for the servicing operation provide adequate information to monitor servicing activities. Reports by asset pool or transaction should include:

    a. Activity data, including:

        - Aggregate data such as number of loans, dollar amount of loans, yield on loans.
        - Delinquency information for at least the loans that are more than 15/30/60/90 days past due;
        - Number and dollar amount of early payment default (within first three months of closing);
        - Charge-off data; and
        - Repossession costs (if applicable).

    b. Profitability information, including all costs associated with direct and indirect overhead, capital, and collections.

    c. Comparisons of the servicer's costs and revenues with industry averages.

46. Evaluate management's planning process for future servicing activities. Determine whether:

    a. Current systems are capable of handling the requirements for the current and anticipated securitization volume.

    b. The planning process for the development of operating systems has been coordinated with plans for anticipated future growth in servicing obligations.

    c. Provisions exist for complete testing and personnel training before adding systems or changing existing ones significantly.

    d. A sufficient number of experienced credit administration and workout personnel are available to meet the added demands associated with increased transaction and account volumes.

47. Determine whether the bank has contracted for an appropriate amount of errors and omissions insurance to cover the risks associated with the added transaction volumes from securitization activities.

48. Determine whether internal or external auditors review the servicing function. Determine whether they:

    a. Verify loan balances.

    b. Verify notes, mortgages, security interests, collateral, etc., with outside custodians.

    c. Review loan collection and repossession activities to determine that the servicer:

        - Promptly identifies problem loans;
        - Charges off loans in a timely manner;
        - Follows written guidelines for extensions, renegotiations, and renewal of loans;
        - Clears stale items from suspense accounts in a timely manner; and
        - Accounts for servicing fees properly (by amortizing excess servicing fees, for example).

**Collections**

49. Review policies and procedures for collecting delinquent loans.

    a. Determine whether collection efforts are consistent with pooling and servicing agreement guidelines.

    b. Determine whether the bank documents all attempts to collect past-due payments, including the date(s) of borrower contact, the nature of communication, and the borrower's response/comment.

    c. Evaluate methods used by management to ensure that collection procedures comply with applicable state and federal laws and regulations.

## Other Roles

### Credit Enhancement Provider

50. If the bank enhances the credit of securitized products it *originates*, ensure that:

    a. It appropriately classifies the transactions as “financings” or “sales.”

    b. Accounting for this obligation does not underestimate predictable losses or overestimate the adequacy of loan loss reserves.

    c. Standards for enhancing the bank’s own originations are not more liberal than standards applied to securitized products originated by others.

51. Ensure that the authority to enhance the credit of other banks’ securitization programs is solely in the hands of credit personnel.

52. Determine that *all* credit enhancement exposures are analyzed during the bank’s internal credit review process. At a minimum, ensure that:

    a. The accounting for this contingent obligation does not underestimate predictable loan losses or overestimate the adequacy of loan loss reserves.

    b. The limits on securitized credits that the bank enhances reflect the bank’s overall exposure to the originator and packager of the securitized credits.

    c. The bank consolidates its exposure to securitized credits it enhances with exposure to the same credits held in its own loan portfolio.

53. Determine whether the bank has established exposure limits for pertinent credit criteria, such as the enhancer’s exposure by customers, industry, and geography. Determine whether these exposures are incorporated into systemic exposure reports.

54. Ascertain whether the bank has the capacity to fund the support they have provided. Evaluate whether the bank considers this contingent obligation in its contingency funding plans.

55. Determine that the bank's business plan for credit enhancement addresses capital allocation and ensure that the associated costs of capital usage are incorporated into pricing and transaction decisions.

56. If credit enhancement facilities are provided for third parties, ensure that risk-based capital allocations are consistent with current guidelines set forth in 12 CFR 3 and the "Instructions for the Consolidated Reports of Condition and Income."

**Trustee**

These procedures supplement those in the *Comptroller's Handbook for National Trust Examiners* and are intended only to guide examiners during the evaluation of the trustee's role in the securitization process.

57. Determine whether all indentures and contracts have been reviewed by appropriate legal counsel. Establish whether the agreements have been carefully worded to specify only services that the bank is capable of performing.

58. Review how bank management evaluates proposed customers and transactions that involve the bank as trustee. At a minimum, an evaluation should consider:

    a. The bank's capacity to perform all the tasks being requested.

    b. The financial and ethical backgrounds of the customer.

    c. The reputation and financial risks of entering into a relationship with the customer or acting as trustee for the transaction.

59. Review conflicts of interest that could arise when the bank trustee acts in an additional capacity in the securitization process. If the potential for conflicts of interest is apparent, determine whether the bank's legal

counsel has reviewed the situation and rendered an opinion on its propriety.

60. Determine whether the audit of trust work on securitized products is adequate.

**Liquidity Enhancement Provider**

61. Review agreements in which the bank agrees to provide back-up liquidity (either as a servicer or third-party provider of liquidity enhancement), and determine whether liquidity will be provided in the event of credit problems. Consider whether:

    a. The bank (as liquidity provider) is required to advance for delinquent receivables.

    b. The liquidity agreements cite credit-related contingencies that would allow the bank to withhold advances.

62. If the bank, in agreeing to provide back-up liquidity, assumes any risk of loss that would constitute providing recourse, ensure that appropriate risk-based capital is maintained by the bank.

**Underwriter and Packager**

63. Determine whether legal counsel has been used in arriving at appropriate policies and procedures governing due diligence and disclosure to investors.

    a. Ascertain whether the bank's policy or practices require the bank to inform customers that nonpublic information in the bank's possession may be disclosed as part of the underwriting process. If not, determine whether legal counsel concurred with the decision not to provide the disclosure and ensure that the rationale behind it has been documented.

    b. Determine whether the bank has procedures to disclose all material information to investors.

c. Determine whether the bank has procedures to ensure that:

- Publicly offered securities are registered under the Securities Act of 1933; or
- Any reliance upon an exemption from registration (privately offered securities are exempt from such registration) is supported by the opinion of counsel.

64. Evaluate the measures taken to limit the bank's exposure in the event that an issue the institution has agreed to underwrite cannot be sold. Review systems used to quantify underwriting risks and to establish risk limits. Consider:

    - Funding capacity necessary to support temporary and long-term inventory positions;
    - Balance sheet compatibility;
    - Diversity of customer sales base and prospects for subsequent sale; and
    - Hedging strategies.

65. Ascertain whether the bank is prepared to make a market for all asset-backed securities that it underwrites. Also, determine whether this question is addressed in the bank's contingency funding plan.

66. Determine whether the bank monitors securities it has underwritten and adjusts funding plans according to noted or perceived market shifts and investor actions.

67. Review the bank's files for current information on the asset-backed security originator, credit enhancer, and other pertinent parties. Assess the ability of these parties to meet their obligations.

## Overall Conclusions

68. Prepare a summary memorandum detailing the results of the asset securitization examination. Address the following:

a. Adequacy of risk management systems, including the bank's ability to identify, measure, monitor, and control the risks of securitization.

b. Adequacy of the strategic plan or business plan for asset securitization.

c. Adequacy of policies and operating procedures and adherence thereto.

d. Quality and depth of management supervision and operating personnel.

e. Adequacy of management information systems.

f. Propriety of accounting systems and regulatory reporting.

g. Compliance with applicable laws, rulings, and regulations.

h. Adequacy of audit, compliance, and credit reviews.

I. Recommended corrective action regarding deficient policies, procedures, or practices and other concerns.

j. Commitments received from management to address concerns.

k. The impact of securitization activities on reputation risk, strategic risk, credit risk, transaction risk, liquidity risk, and compliance risk.

l. The impact of securitization activities on the bank's earnings and capital.

m. The bank's future prospects based on its finances and other considerations.

n. Other matters of significance.

69. Discuss examination findings and conclusions with the EIC. Based on

this discussion, set up a meeting with bank management to share findings and obtain any necessary commitments for corrective action.

70. Write a memorandum specifically setting out what the OCC needs to do in the future to effectively supervise the asset securitization function. Include time frames, staffing, and workdays required.

71. Update the examination work papers.

## Regulations

12 CFR 3, Minimum Capital Ratios; Issuance of Directives (including Appendix A)

## Issuances

Banking Circular 177, “Corporate Contingency Planning”
*Comptroller’s Handbook* , “Capital and Dividends”
*Comptroller’s Handbook* , “Mortgage Banking”
*Comptroller’s Handbook for National Bank Examiners*, “Funds Management,” Section 405
Consolidated Reports of Condition and Income (the Call Reports)
Financial Accounting Standard 125, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities”
OCC 96-52, “Securitization — Guidelines for National Banks”

# OCC BULLETIN

Comptroller of the Currency
Administrator of National Banks

Subject: Interagency Guidance on Asset Securitization Activities

Description: Asset Securitization

TO: Chief Executive Officers of All National Banks, Department and Division Heads, and All Examining Personnel

The attached "Interagency Guidance on Asset Securitization Activities" was issued jointly by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (the Agencies) on December 13, 1999. The provisions included in this policy statement are effective immediately.

For several years, large commercial banks have been using asset securitization as an alternative method of funding balance sheet assets, improving financial performance ratios and generating fee income. While the OCC continues to endorse the use of asset securitization as a tool to manage the bank's balance sheet and more efficiently meet customer needs, we remind bankers that such activity is only appropriate when properly managed. During recent examinations, our examiners have noted an unacceptable number of national banks with risk management systems or internal control infrastructures insufficient to support the institution's securitization activities. Particularly disturbing is the number of cases where the valuation of retained interests on the bank's balance sheet have not been in compliance with the standards prescribed in Statement of Financial Accounting Standard No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." In addition, several banks have inaccurately reported their risk-based capital by failing to appropriately account for recourse obligations arising from securitization activities.

The attached statement highlights particular areas of weakness, including the board and senior management oversight. **The statement reiterates our expectation that critical components of an effective oversight program for asset securitization activities include: (1) independent risk management commensurate with the complexity of securitization activities, (2) comprehensive audit coverage, (3) appropriate residual interest valuation and modeling methodologies, (4) accurate and timely risk-based capital calculations, and (5) prudent internal limits to control the amount of equity capital at risk that is used to support securitization retained interests.**

OCC examiners will continue to review asset securitization activities in national banks to ensure that the board of directors and senior management are complying with the risk management expectations detailed in this policy statement. In those cases where examiners identify weak risk management practices or lax internal controls, bank management will be directed to take immediate corrective action. In situations where bank management cannot provide objectively verifiable support for the valuation of the retained interest, the asset will be classified as loss and disallowed as an asset of the bank for regulatory capital purposes.

Additional guidance on OCC expectations for national banks involved in asset securitization activities can be found in the "Asset Securitization" booklet of the *Comptroller's Handbook.*

Questions about the interagency statement or other policy issues related to asset securitization activities may be directed to Kathy Dick, Director, Treasury and Market Risk Division at (202) 874-5670. Technical assistance can be provided by Greg Coleman or Jeffery Power at the same location.

Emory Wayne Rushton
Senior Deputy Comptroller
Bank Supervision Policy

Attachment

**Office of the Comptroller of the Currency**
**Federal Deposit Insurance Corporation**
**Board of Governors of the Federal Reserve System**
**Office of Thrift Supervision**

# INTERAGENCY GUIDANCE ON ASSET SECURITIZATION ACTIVITIES

## BACKGROUND AND PURPOSE

Recent examinations have disclosed significant weaknesses in the asset securitization practices of some insured depository institutions. These weaknesses raise concerns about the general level of understanding and controls among institutions that engage in such activities. The most frequently encountered problems stem from: (1) the failure to recognize and hold sufficient capital against explicit and implicit recourse obligations that frequently accompany securitizations, (2) the excessive or inadequately supported valuation of "retained interests,"[1] (3) the liquidity risk associated with over reliance on asset securitization as a funding source, and (4) the absence of adequate independent risk management and audit functions.

The Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision, hereafter referred to as "the Agencies," are jointly issuing this statement to remind financial institution managers and examiners of the importance of fundamental risk management practices governing asset securitization activities. This guidance supplements existing policy statements and examination procedures issued by the Agencies and emphasizes the specific expectation that any securitization-related retained interest claimed by a financial institution will be supported by documentation of the interest's fair value, utilizing reasonable, conservative valuation assumptions that can be objectively verified. Retained interests that lack such objectively verifiable support or that fail to meet the supervisory standards set forth in this document will be classified as loss and disallowed as assets of the institution for regulatory capital purposes.

The Agencies are reviewing institutions' valuation of retained interests and the concentration of these assets relative to capital. Consistent with existing supervisory authority, the Agencies may, on a case-

[1] In securitizations, a seller typically retains one or more interests in the assets sold. **Retained interests** represent the right to cash flows and other assets not used to extinguish bondholder obligations and pay credit losses, servicing fees and other trust related fees. For the purposes of this statement, **retained interests** include over-collateralization, spread accounts, cash collateral accounts, and interest only strips (IO strips). Although servicing assets and liabilities also represent a retained interest of the seller, they are currently determined based on different criteria and have different accounting and risk-based capital requirements. See applicable comments in Statement of Financial Accounting Standard No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" (FAS 125), for additional information about these interests and associated accounting requirements.

by-case basis, require institutions that have high concentrations of these assets relative to their capital, or are otherwise at risk from impairment of these assets, to hold additional capital commensurate with their risk exposures. Furthermore, given the risks presented by these activities, the Agencies are actively considering the establishment of regulatory restrictions that would limit or eliminate the amount of certain retained interests that may be recognized in determining the adequacy of regulatory capital. An excessive dependence on securitizations for day-to-day core funding can also present significant liquidity problems - either during times of market turbulence or if there are difficulties specific to the institution itself. As applicable, the Agencies will provide further guidance on the liquidity risk associated with over reliance on asset securitizations as a funding source and implicit recourse obligations.

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## DESCRIPTION OF ACTIVITY

Asset securitization typically involves the transfer of on-balance sheet assets to a third party or trust. In turn the third party or trust issues certificates or notes to investors. The cash flow from the transferred assets supports repayment of the certificates or notes. For several years, large financial institutions, and a growing number of regional and community institutions, have been using asset securitization to access alternative funding sources, manage concentrations, improve financial performance ratios, and more efficiently meet customer needs. In many cases, the discipline imposed by investors who buy assets at their fair value has sharpened selling institutions' credit risk selection, underwriting, and pricing practices. Assets typically securitized by institutions include credit card receivables, automobile receivable paper, commercial and residential first mortgages, commercial loans, home equity loans, and student loans.

While the Agencies continue to view the use of securitization as an efficient means of financial intermediation, we are concerned about events and trends uncovered at recent examinations. Of particular concern are institutions that are relatively new users of securitization techniques and institutions whose senior management and directors do not have the requisite knowledge of the effect of securitization on the risk profile of the institution or are not fully aware of the accounting, legal and risk-based capital nuances of this activity. Similarly, the Agencies are concerned that some institutions have not fully and accurately distinguished and measured the risks that have been transferred versus those retained, and accordingly are not adequately managing the retained portion. It is essential that institutions engaging in securitization activities have appropriate front and back office staffing, internal and external accounting and legal support, audit or independent review coverage, information systems capacity, and oversight mechanisms to execute, record, and administer these transactions correctly.

Additionally, we are concerned about the use of inappropriate valuation and modeling methodologies to determine the initial and ongoing value of retained interests. Accounting rules provide a method to recognize an immediate gain (or loss) on the sale through booking a "retained interest;" however, the carrying value of that interest must be fully documented, based on reasonable assumptions, and regularly analyzed for any subsequent value impairment. The best evidence of fair value is a quoted market price in an active market. In circumstances where quoted market prices are not available, accounting rules allow fair value to be estimated. This estimate must be based on the "best information available in the circumstances."[2] An estimate of fair value must be supported by reasonable and current assumptions. If a best estimate of fair value is not practicable, the asset is to be recorded at zero in financial and regulatory reports.

History shows that unforeseen market events that affect the discount rate or performance of receivables supporting a retained interest can swiftly and dramatically alter its value. Without appropriate internal controls and independent oversight, an institution that securitizes assets may inappropriately generate "paper profits" or mask actual losses through flawed loss assumptions, inaccurate prepayment rates, and inappropriate discount rates. Liberal and unsubstantiated assumptions can result in material inaccuracies in financial statements, substantial write-downs of retained interests, and, if interests represent an excessive concentration of the institution's capital, the demise of the sponsoring institution.

Recent examinations point to the need for institution managers and directors to ensure that:

- Independent risk management processes are in place to monitor securitization pool performance on an aggregate and individual transaction level. An effective risk management function includes appropriate information systems to monitor securitization activities.

- Conservative valuation assumptions and modeling methodologies are used to establish, evaluate and adjust the carrying value of retained interests on a regular and timely basis.

- Audit or internal review staffs periodically review data integrity, model algorithms, key underlying assumptions, and the appropriateness of the valuation and modeling process for the securitized assets retained by the institution. The findings of such reviews should be reported directly to the board or an appropriate board committee.

- Accurate and timely risk-based capital calculations are maintained, including recognition and reporting of any recourse obligation resulting from securitization activity.

- Internal limits are in place to govern the maximum amount of retained interests as a percentage of total equity capital.

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[2] FAS 125, at par. 43

- The institution has a realistic liquidity plan in place in case of market disruptions.

The following sections provide additional guidance relating to these and other critical areas of concern. Institutions that lack effective risk management programs or that maintain exposures in retained interests that warrant supervisory concern may be subject to more frequent supervisory review, more stringent capital requirements, or other supervisory action.

## INDEPENDENT RISK MANAGEMENT FUNCTION

Institutions engaged in securitizations should have an independent risk management function commensurate with the complexity and volume of their securitizations and their overall risk exposures. The risk management function should ensure that securitization policies and operating procedures, including clearly articulated risk limits, are in place and appropriate for the institution's circumstances. A sound asset securitization policy should include or address, at a minimum:

- A written and consistently applied accounting methodology;
- Regulatory reporting requirements;
- Valuation methods, including FAS 125 residual value assumptions, and procedures to formally approve changes to those assumptions;
- Management reporting process; and
- Exposure limits and requirements for both aggregate and individual transaction monitoring.

It is essential that the risk management function monitor origination, collection, and default management practices. This includes regular evaluations of the quality of underwriting, soundness of the appraisal process, effectiveness of collections activities, ability of the default management staff to resolve severely delinquent loans in a timely and efficient manner, and the appropriateness of loss recognition practices. Because the securitization of assets can result in the current recognition of <u>anticipated income</u>, the risk management function should pay particular attention to the types, volumes, and risks of assets being originated, transferred and serviced. Both senior management and the risk management staff must be alert to any pressures on line managers to originate abnormally large volumes or higher risk assets in order to sustain ongoing income needs. Such pressures can lead to a compromise of credit underwriting standards. This may accelerate credit losses in future periods, impair the value of retained interests and potentially lead to funding problems.

The risk management function should also ensure that appropriate management information systems (MIS) exist to monitor securitization activities. Reporting and documentation methods must support the initial valuation of retained interests and ongoing impairment analyses of these assets. Pool performance information has helped well-managed institutions to ensure, on a qualitative basis, that a sufficient amount of economic capital is being held to cover the various risks inherent in securitization transactions.

The absence of quality MIS hinders management's ability to monitor specific pool performance and securitization activities more broadly.  At a minimum, MIS reports should address the following:

***Securitization summaries for each transaction* -** The summary should include relevant transaction terms such as collateral type, facility amount, maturity, credit enhancement and subordination features, financial covenants (termination events and spread account capture "triggers"), right of repurchase, and counterparty exposures.  Management should ensure that the summaries are distributed to all personnel associated with securitization activities.

***Performance reports by portfolio and specific product type* -** Performance factors include gross portfolio yield, default rates and loss severity, delinquencies, prepayments or payments, and excess spread amounts.  The reports should reflect performance of assets, both on an individual pool basis and total managed assets.  These reports should segregate specific products and different marketing campaigns.

***Vintage analysis for each pool using monthly data* -** Vintage analysis helps management understand historical performance trends and their implications for future default rates, prepayments, and delinquencies, and therefore retained interest values. Management can use these reports to compare historical performance trends to underwriting standards, including the use of a validated credit scoring model, to ensure loan pricing is consistent with risk levels.  Vintage analysis also helps in the comparison of deal performance at periodic intervals and validates retained interest valuation assumptions.

***Static pool cash collection analysis* -** This analysis entails reviewing monthly cash receipts relative to the principal balance of the pool to determine the cash yield on the portfolio, comparing the cash yield to the accrual yield, and tracking monthly changes.  Management should compare the timing and amount of cash flows received from the trust with those projected as part of the FAS 125 retained interest valuation analysis on a monthly basis.  Some master trust structures allow excess cash flow to be shared between series or pools.  For revolving asset trusts with this master trust structure, management should perform a cash collection analysis for each master trust structure.  These analyses are essential in assessing the actual performance of the portfolio in terms of default and prepayment rates.  If cash receipts are less than those assumed in the original valuation of the retained interest, this analysis will provide management and the board with an early warning of possible problems with collections or extension practices, and impairment of the retained interest.

***Sensitivity analysis* -** Measuring the effect of changes in default rates, prepayment or payment rates, and discount rates will assist management in establishing and validating the carrying value of the retained interest.  Stress tests should be performed at least quarterly.  Analyses should consider potential adverse trends and determine "best," "probable," and "worst case" scenarios for each event.  Other factors to consider are the impact of increased defaults on collections staffing, the timing of cash flows, "spread account" capture triggers, over-collateralization triggers, and early amortization triggers.  An increase in defaults can result in higher than expected costs and a delay in cash flows, decreasing the value of the retained interests.  Management should periodically quantify and document the potential impact to both earnings and capital, and report the results to the board of directors**.** Management should incorporate this analysis into their overall interest rate risk measurement system.[3] Examiners will review the analysis conducted by the institution and the volatility associated with retained interests when assessing the Sensitivity to Market Risk component rating.

***Statement of covenant compliance*** - Ongoing compliance with deal performance triggers as defined by the pooling and servicing agreements should be affirmed at least monthly. Performance triggers include early amortization, spread capture, changes to over-collateralization requirements, and events that would result in servicer removal.

## VALUATION AND MODELING PROCESSES

The method and key assumptions used to value the retained interests and servicing assets or liabilities must be reasonable and fully documented. The key assumptions in all valuation analyses include prepayment or payment rates, default rates, loss severity factors, and discount rates. The Agencies expect institutions to take a logical and conservative approach when developing securitization assumptions and capitalizing future income flows. It is important that management quantifies the assumptions on a pool-by-pool basis and maintains supporting documentation for all changes to the assumptions as part of the valuation process, which should be done no less than quarterly. Policies should define the acceptable reasons for changing assumptions and require appropriate management approval.

An exception to this pool-by-pool valuation analysis may be applied to revolving asset trusts if the master trust structure allows excess cash flows to be shared between series. In a master trust, each certificate of each series represents an undivided interest in all of the receivables in the trust. Therefore, valuations are appropriate at the master trust level.

In order to determine the value of the retained interest at inception, and make appropriate adjustments going forward, the institution must implement a reasonable modeling process to comply with FAS 125. The Agencies expect management to employ reasonable and conservative valuation assumptions and projections, and to maintain verifiable objective documentation of the fair value of the retained interest. Senior management is responsible for ensuring the valuation model accurately reflects the cash flows according to the terms of the securitization's structure. For example, the model should account for any cash collateral or over-collateralization triggers, trust fees, and insurance payments if appropriate. The board and management are accountable for the "model builders" possessing the necessary expertise and technical proficiency to perform the modeling process. Senior management should ensure that internal controls are in place to provide for the ongoing integrity of MIS associated with securitization activities.

As part of the modeling process, the risk management function should ensure that periodic validations

[3] Under the Joint Agency Policy Statement on Interest Rate Risk, institutions with a high level of exposure to interest rate risk relative to capital will be directed to take corrective action. Savings associations can find OTS guidance on interest rate risk in Thrift Bulletin 13a - Management of Interest Rate Risk, Investment Securities, and Derivative Activities.

are performed in order to reduce vulnerability to model risk. Validation of the model includes testing the internal logic, ensuring empirical support for the model assumptions, and back-testing the models with actual cash flows on a pool-by-pool basis. The validation process should be documented to support conclusions. Senior management should ensure the validation process is independent from line management as well as the modeling process. The audit scope should include procedures to ensure that the modeling process and validation mechanisms are both appropriate for the institution's circumstances and executed consistent with the institution's asset securitization policy.

## USE OF OUTSIDE PARTIES

Third parties are often engaged to provide professional guidance and support regarding an institution's securitization activities, transactions, and valuing of retained interests. The use of outside resources does not relieve directors of their oversight responsibility, or senior management of its responsibilities to provide supervision, monitoring, and oversight of securitization activities, and the management of the risks associated with retained interests in particular. Management is expected to have the experience, knowledge, and abilities to discharge its duties and understand the nature and extent of the risks presented by retained interests and the policies and procedures necessary to implement an effective risk management system to control such risks. Management must have a full understanding of the valuation techniques employed, including the basis and reasonableness of underlying assumptions and projections.

## INTERNAL CONTROLS

Effective internal controls are essential to an institution's management of the risks associated with securitization. When properly designed and consistently enforced, a sound system of internal controls will help management safeguard the institution's resources, ensure that financial information and reports are reliable, and comply with contractual obligations, including securitization covenants. It will also reduce the possibility of significant errors and irregularities, as well as assist in their timely detection when they do occur. Internal controls typically: (1) limit authorities, (2) safeguard access to and use of records, (3) separate and rotate duties, and (4) ensure both regular and unscheduled reviews, including testing.

The Agencies have established operational and managerial standards for internal control and information systems.[4] An institution should maintain a system of internal controls appropriate to its size and the nature, scope, and risk of its activities. Institutions that are subject to the requirements of FDIC regulation 12 CFR Part 363 should include an assessment of the effectiveness of internal controls over their asset securitization activities as part of management's report on the overall effectiveness of the system of internal controls over financial reporting. This assessment implicitly includes the internal controls over financial information that is included in regulatory reports.

[4] Safety and Soundness Standards 12 CFR Part 30 (OCC), 12 CFR Part 570 (OTS).

## AUDIT FUNCTION OR INTERNAL REVIEW

It is the responsibility of an institution's board of directors to ensure that its audit staff or independent review function is competent regarding securitization activities. The audit function should perform periodic reviews of securitization activities, including transaction testing and verification, and report all findings to the board or appropriate board committee. The audit function also may be useful to senior management in identifying and measuring risk related to securitization activities. Principal audit targets should include compliance with securitization policies, operating and accounting procedures (FAS 125), and deal covenants, and accuracy of MIS and regulatory reports. The audit function should also confirm that the institution's regulatory reporting process is designed and managed in such a way to facilitate timely and accurate report filing. Furthermore, when a third party services loans, the auditors should perform an independent verification of the existence of the loans to ensure balances reconcile to internal records.

## REGULATORY REPORTING

The securitization and subsequent removal of assets from an institution's balance sheet requires additional reporting as part of the regulatory reporting process. Common regulatory reporting errors stemming from securitization activities include:

- Failure to include off-balance sheet assets subject to recourse treatment when calculating risk-based capital ratios;
- Failure to recognize retained interests and retained subordinate security interests as a form of credit enhancement;
- Failure to report loans sold with recourse in the appropriate section of the regulatory report; and
- Over-valuing retained interests.

An institution's directors and senior management are responsible for the accuracy of its regulatory reports. Because of the complexities associated with securitization accounting and risk-based capital treatment, attention should be directed to ensuring that personnel who prepare these reports maintain current knowledge of reporting rules and associated interpretations. This often will require ongoing support by qualified accounting and legal personnel.

Institutions that file the Report of Condition and Income (Call Report) should pay particular attention to the following schedules on the Call Report when institutions are involved in securitization activities: *Schedule RC-F: Other Assets*; *Schedule RC-L: Off Balance Sheet Items*; and *Schedule RC-R: Regulatory Capital*. Institutions that file the Thrift Financial Report (TFR) should pay particular attention to the following TFR schedules: *Schedule CC: Consolidated Commitments and Contingencies, Schedule CCR: Consolidated Capital Requirement, and Schedule CMR: Consolidated Maturity and Rate.*

Under current regulatory report instructions, when an institution's supervisory agency's interpretation of how generally accepted accounting principles (GAAP) should be applied to a specified event or transaction differs from the institution's interpretation, the supervisory agency may require the institution to reflect the event or transaction in its regulatory reports in accordance with the agency's interpretation and amend previously submitted reports.

## MARKET DISCIPLINE AND DISCLOSURES

Transparency through public disclosure is crucial to effective market discipline and can reinforce supervisory efforts to promote high standards in risk management. Timely and adequate information on the institution's asset securitization activities should be disclosed. The information contained in the disclosures should be comprehensive; however, the amount of disclosure that is appropriate will depend on the volume of securitizations and complexity of the institution. Well-informed investors, depositors, creditors and other bank counterparties can provide a bank with strong incentives to maintain sound risk management systems and internal controls. Adequate disclosure allows market participants to better understand the financial condition of the institution and apply market discipline, creating incentives to reduce inappropriate risk taking or inadequate risk management practices. Examples of sound disclosures include:

- Accounting policies for measuring retained interests, including a discussion of the impact of key assumptions on the recorded value;

- Process and methodology used to adjust the value of retained interests for changes in key assumptions;

- Risk characteristics, both quantitative and qualitative, of the underlying securitized assets;

- Role of retained interests as credit enhancements to special purpose entities and other securitization vehicles, including a discussion of techniques used for measuring credit risk; and

- Sensitivity analyses or stress testing conducted by the institution showing the effect of changes in key assumptions on the fair value of retained interests.

## RISK-BASED CAPITAL FOR RECOURSE AND LOW LEVEL RECOURSE TRANSACTIONS

For regulatory purposes, recourse is generally defined as an arrangement in which an institution retains the risk of credit loss in connection with an asset transfer, if the risk of credit loss exceeds a pro rata share of the institution's claim on the assets.[5] In addition to broad contractual language that may require

[5] The risk-based capital treatment for sales with recourse can be found at 12 CFR Part 3 Appendix A, Section (3)(b)(1)(iii) {OCC}, 12 CFR Part 567.6(a)(2)(i)(c) {OTS}. For a further explanation of recourse see the glossary entry "Sales of Assets for Risk-Based Capital Purposes" in the instructions for the Call Report.

the selling institution to support a securitization, recourse can also arise from retained interests, retained subordinated security interests, the funding of cash collateral accounts, or other forms of credit enhancements that place an institution's earnings and capital at risk. These enhancements should generally be aggregated to determine the extent of an institution's support of securitized assets. Although an asset securitization qualifies for sales treatment under GAAP, the underlying assets may still be subject to regulatory risk-based capital requirements. Assets sold with recourse should generally be risk-weighted as if they had not been sold.

Securitization transactions involving recourse may be eligible for "low level recourse" treatment.[6] The Agencies' risk-based capital standards provide that the dollar amount of risk-based capital required for assets transferred with recourse should not exceed the maximum dollar amount for which an institution is contractually liable. The "low level recourse" treatment applies to transactions accounted for as sales under GAAP in which an institution contractually limits its recourse exposure to less than the full risk-based capital requirements for the assets transferred. Under the low level recourse principle, the institution holds capital on approximately a dollar-for-dollar basis up to the amount of the aggregate credit enhancements.

Low level recourse transactions should be reported in Schedule RC-R of the Call Report or Schedule CCR of the TFR using either the "direct reduction method" or the "gross-up method" in accordance with the regulatory report instructions.

If an institution does not contractually limit the maximum amount of its recourse obligation, or if the amount of credit enhancement is greater than the risk-based capital requirement that would exist if the assets were not sold, the low level recourse treatment does not apply. Instead, the institution must hold risk-based capital against the securitized assets as if those assets had not been sold.

Finally, as noted earlier, retained interests that lack objectively verifiable support or that fail to meet the supervisory standards set for in this document will be classified as loss and disallowed as assets of the institution for regulatory capital purposes.

## INSTITUTION IMPOSED CONCENTRATION LIMITS ON RETAINED INTERESTS

The creation of a retained interest (the debit) typically also results in an offsetting "gain on sale" (the credit) and thus generation of an asset. Institutions that securitize high yielding assets with long durations may create a retained interest asset value that exceeds the risk-based capital charge that would be in place if the institution had not sold the assets (under the existing risk-based capital guidelines, capital is not required for the amount over eight percent of the securitized assets). Serious problems can arise for institutions that distribute contrived earnings only later to be faced with a downward valuation and charge-off of part or all of the retained interests.

[6] The banking agencies' low level recourse treatment is described in the Federal Register in the following locations: 60 Fed. Reg. 17986 (April 10, 1995) (OCC); 60 Fed. Reg. 8177 (February 13, 1995)(FRB); 60 Fed. Reg. 15858 (March 28,1995)(FDIC). OTS has had a low level recourse rule in 12 CFR Part 567.6(a)(2)(i)(c) since 1989. A brief explanation is also contained in the instructions for regulatory reporting in section RC-R for the Call Report or schedule CCR for the TFR.

As a basic example, an institution could sell $100 in subprime home equity loans and book a retained interest of $20 using liberal "gain on sale" assumptions. Under the current capital rules, the institution is required to hold approximately $8 in capital. This $8 is the current capital requirement if the loans were never removed from the balance sheet (eight percent of $100 = $8). However, the institution is still exposed to substantially all of the credit risk, plus the additional risk to earnings and capital from the volatility of the retained interest. If the value of the retained interest decreases to $10 due to inaccurate assumptions or changes in market conditions, the $8 in capital is insufficient to cover the entire loss.

Normally, the sponsoring institution will eventually receive any excess cash flow remaining from securitizations after investor interests have been met. However, recent experience has shown that retained interests are vulnerable to sudden and sizeable write-downs that can hinder an institution's access to the capital markets, damage its reputation in the market place, and in some cases, threaten its solvency. Accordingly, the Agencies expect an institution's board of directors and management to develop and implement policies that limit the amount of retained interests that may be carried as a percentage of total equity capital, based on the results of their valuation and modeling processes. Well constructed internal limits also serve to lessen the incentive of institution personnel to engage in activities designed to generate near term "paper profits" that may be at the expense of the institution's long term financial position and reputation.

## SUMMARY

Asset securitization has proven to be an effective means for institutions to access new and diverse funding sources, manage concentrations, improve financial performance ratios, and effectively serve borrowing customers. However, securitization activities also present unique and sometimes complex risks that require board and senior management attention. Specifically, the initial and ongoing valuation of retained interests associated with securitization, and the limitation of exposure to the volatility represented by these assets, warrant immediate attention by management.

Moreover, as mentioned earlier in this statement, the Agencies are studying various issues relating to securitization practices, including whether restrictions should be imposed that would limit or eliminate the amount of retained interests that qualify as regulatory capital. In the interim, the Agencies will review affected institutions on a case-by-case basis and may require, in appropriate circumstances, that institutions hold additional capital commensurate with their risk exposure. In addition, the Agencies will study, and issue further guidance on, institutions' exposure to implicit recourse obligations and the liquidity risk associated with over reliance on asset securitization as a funding source.

OCC 2007-1

# OCC BULLETIN

Comptroller of the Currency
Administrator of National Banks

Subject: **Complex Structured Finance Transactions** Description: **Notice of Final Interagency Statement**

Date: January 5, 2007

**TO:** Chief Executive Officers of National Banks, Department and Division Heads, All Examining Personnel, and Other Interested Parties

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the Securities and Exchange Commission (the agencies) are adopting the attached "Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities" that may pose heightened legal or reputational risks to financial institutions. The statement was issued on January 5, 2007, and will be published in the *Federal Register*.

## SUMMARY

In May 2004, the agencies issued and requested comment on a proposed "Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities" (initial statement). After carefully considering comments received, the agencies issued a revised statement for comment in May 2006. The modifications to the initial statement addressed issues and concerns raised by commenters. These modifications made the statement more principles-based; focused the statement on those complex structured finance transactions (CSFTs) that may pose heightened levels of legal or reputational risk to the relevant institution (referred to as elevated risk CSFTs); recognized more explicitly that an institution's review and approval process for elevated risk CSFTs should be commensurate with, and should focus on, the potential risks presented by the transaction to the institution; clarified that the statement does not create any private rights of action, nor does it alter or expand the legal duties and obligations that a financial institution may have to a customer, to its shareholders, or to other third parties under applicable law; and noted that it does not affect the vast majority of financial institutions, including most small financial institutions. The agencies have adopted the final statement with minor modifications designed to clarify, but not alter, the principles outlined in the revised statement.

Examples of CSFTs that often pose elevated risks and thus would be covered by the final statement include transactions that:

- Lack economic substance or business purpose;

- Are designed or used primarily for questionable accounting, regulatory, or tax objectives, particularly when the transactions are executed at year end or at the end of a reporting period for the customer;
- Raise concerns that the client will report or disclose the transaction in its public filings or financial statements in a manner that is materially misleading or inconsistent with the substance of the transaction or with applicable regulatory or accounting requirements;
- Involve circular transfers of risk (either between the financial institution and the customer or between the customer and other related parties) that lack economic substance or business purpose;
- Involve oral or undocumented agreements that, when taken into account, would have a material impact on the regulatory, tax, or accounting treatment of the related transaction, or the client's disclosure obligations;
- Have material economic terms that are inconsistent with market norms (*e.g.*, deep "in the money" options or historic rate rollovers); or
- Provide the financial institution with compensation that appears substantially disproportionate to the services provided or investment made by the financial institution or to the credit, market, or operational risk assumed by the institution.

The statement points out that if a financial institution determines through its due diligence that participation in a particular CSFT would create significant legal or reputational risks for the institution, the institution should take appropriate steps to address those risks. Such actions may include declining to participate in the transaction, or conditioning its participation upon the receipt of representations or assurances from the customer that reasonably address the heightened legal or reputational risks presented by the transaction. The statement also establishes that a financial institution should decline to participate in an elevated risk CSFT if, after conducting appropriate due diligence and taking appropriate steps to address the risks from the transaction, the institution determines that the transaction presents unacceptable risk to the institution or would result in a violation of applicable laws, regulations, or accounting principles.

**FURTHER INFORMATION**

For further information, please contact Kathy Dick, Deputy Comptroller for Credit and Market Risk, (202) 874-4660; Grace Dailey, Deputy Comptroller for Large Banks, (202) 874-4610; or Ellen Broadman, Director, Securities and Corporate Practices Division, (202) 874-5210.

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Attachment – http://www.occ.treas.gov/ftp/bulletin/2007-1a.pdf
[http://www.occ.treas.gov/ftp/bulletin/2007-1a.pdf]

**DEPARTMENT OF THE TREASURY**
**Office of the Comptroller of the Currency**
**[Docket No. 06-17]**

**Office of Thrift Supervision**
**[Docket No. 2006-55]**

**FEDERAL RESERVE SYSTEM**
**[Docket No. OP-1254]**

**FEDERAL DEPOSIT INSURANCE CORPORATION**

**SECURITIES AND EXCHANGE COMMISSION**
**[Release No. 34-55043; File No. S7-08-06]**

# Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities

**AGENCIES:** Office of the Comptroller of the Currency, Treasury ("OCC"); Office of Thrift Supervision, Treasury ("OTS"); Board of Governors of the Federal Reserve System ("Board"); Federal Deposit Insurance Corporation ("FDIC"); and Securities and Exchange Commission ("SEC") (collectively, the "Agencies").

**ACTION:** Notice of final interagency statement.

**SUMMARY:** The Agencies are adopting an Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities ("Final Statement"). The Final Statement pertains to national banks, state banks, bank holding companies (other than foreign banks), federal and state savings associations, savings and loan holding companies, U.S. branches and agencies of foreign banks, and SEC-registered broker-dealers and investment advisers (collectively, "financial institutions" or "institutions") engaged in complex structured finance transactions ("CSFTs"). In May 2004, the Agencies issued and requested comment on a proposed interagency statement ("Initial Proposed Statement"). After reviewing the comments received on the Initial Proposed Statement, the Agencies in May 2006 issued and requested comment on a revised proposed interagency statement ("Revised Proposed Statement"). The modifications to the Revised Proposed Statement, among other things, made the statement more principles-based and focused on the identification, review and approval process for those CSFTs that may pose heightened levels of legal or reputational risk to the relevant institution (referred to as "elevated risk CSFTs"). After carefully reviewing the comments on the Revised Proposed Statement, the Agencies have adopted the Final Statement with minor modifications designed to clarify, but not alter, the principles set forth in the Revised Proposed Statement. The Final Statement describes some of the internal controls and risk management procedures that may help financial institutions identify, manage, and address the heightened reputational and legal risks that may arise

from elevated risk CSFTs. As discussed further below, the Final Statement will not affect or apply to the vast majority of financial institutions, including most small institutions, nor does it create any private rights of action.

**EFFECTIVE DATE:** The Final Statement is effective upon [INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER].

**FOR FURTHER INFORMATION CONTACT:**

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Board: Sabeth I. Siddique, Assistant Director, (202) 452-3861, or Virginia Gibbs, Senior Supervisory Financial Analyst, (202) 452-2521, Division of Banking Supervision and Regulation; or Kieran J. Fallon, Assistant General Counsel, (202) 452-5270, or Anne B. Zorc, Senior Attorney, (202) 452-3876, Legal Division, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW, Washington, DC 20551. Users of Telecommunication Device for Deaf (TTD) only, call (202) 263-4869.

FDIC: Jason C. Cave, Associate Director, (202) 898-3548; Division of Supervision and Consumer Protection; or Mark G. Flanigan, Counsel, Supervision and Legislation Branch, Legal Division, (202) 898-7426, Federal Deposit Insurance Corporation, 550 17th Street, NW, Washington, DC 20429.

SEC: Mary Ann Gadziala, Associate Director, Office of Compliance Inspections and Examinations, (202) 551-6207; Catherine McGuire, Chief Counsel, Linda Stamp Sundberg, Senior Special Counsel (Banking and Derivatives), or Randall W. Roy, Branch Chief, Division of Market Regulation, (202) 551-5550, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

**SUPPLEMENTARY INFORMATION:**

## I. Background

Financial markets have grown rapidly over the past decade, and innovations in financial instruments have facilitated the structuring of cash flows and allocation of risk among creditors, borrowers, and investors in more efficient ways. Financial derivatives for market and credit risk, asset-backed securities with customized cash flow features, specialized financial conduits that manage pools of assets, and other types of structured finance transactions serve important purposes, such as diversifying risk, allocating cash flows and reducing cost of capital. As a result, structured finance transactions, including the more complex variations of these transactions, now are an essential part of U.S. and international capital markets.

When a financial institution participates in a CSFT, it bears the usual market, credit, and operational risks associated with the transaction. In some circumstances, a financial institution also may face heightened legal or reputational risks due to its involvement in a CSFT. For example, a financial institution involved in a CSFT may face heightened legal or reputational risk if the customer's regulatory, tax or accounting treatment for the CSFT, or disclosures concerning the CSFT in its public filings or financial statements, do not comply with applicable laws, regulations or accounting principles.[1]

In some cases, certain CSFTs appear to have been used in illegal schemes that misrepresented the financial condition of public companies to investors and regulatory authorities. After conducting investigations, the OCC, Federal Reserve System and SEC took strong and coordinated civil and administrative enforcement actions against certain financial institutions that engaged in CSFTs that appeared to have been designed or used to shield their customers' true financial health from the public. These actions involved the assessment of significant financial penalties on the institutions and required the institutions to take several measures to strengthen their risk management procedures for CSFTs.[2] The complex structured finance relationships involving these financial institutions also sparked an investigation by the Permanent Subcommittee on Governmental Affairs of the United States Senate,[3] as well as numerous lawsuits by private litigants.

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[1] For a memorandum on the potential liability of a financial institution for securities laws violations arising from participation in a CSFT, see Letter from Annette L. Nazareth, Director, Division of Market Regulation, Securities and Exchange Commission, to Richard Spillenkothen and Douglas W. Roeder, dated December 4, 2003 (available at http://www.federalreserve.gov/boarddocs/srletters/2004/ and http://www.occ.treas.gov).

[2] See, e.g., In the Matter of Citigroup, Inc., Securities Exchange Act Release No. 48230 (July 28, 2003), Written Agreement by and between Citibank, N.A. and the Office of the Comptroller of the Currency, No. 2003-77 (July 28, 2003) (pertaining to transactions entered into by Citibank, N.A. with Enron Corp.) and Written Agreement by and between Citigroup, Inc. and the Federal Reserve Bank of New York, dated July 28, 2003 (pertaining to transactions involving Citigroup Inc. and its subsidiaries and Enron Corp. and Dynegy Inc.); SEC v. J.P. Morgan Chase, SEC Litigation Release No. 18252 (July 28, 2003) and Written Agreement by and among J.P. Morgan Chase & Co., the Federal Reserve Bank of New York, and the New York State Banking Department, dated July 28, 2003 (pertaining to transactions involving J.P. Morgan Chase & Co. and its subsidiaries and Enron Corp.).

[3] See Fishtail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and Facilitated by U.S. Financial Institutions, Report Prepared by the Permanent Subcomm. on Investigations, Comm. on Governmental Affairs, United States Senate, S. Rpt. 107-82 (2003).

The OCC, Federal Reserve System and SEC also conducted special reviews of several large financial institutions engaged in CSFTs, and the Agencies have focused attention on the CSFT activities of financial institutions in the normal course of the supervisory process. These reviews and activities indicate that many of the large financial institutions engaged in CSFTs have taken meaningful steps in recent years to improve their control infrastructure relating to CSFTs.

## II. Initial and Revised Proposed Statements

To assist financial institutions in identifying, managing, and addressing the risks that may be associated with CSFTs, the Agencies developed and requested public comment on the Initial Proposed Statement.[4] The Initial Proposed Statement described the types of policies and procedures that a financial institution engaged in CSFTs should have in place to allow the institution to identify, document, evaluate, and control the full range of credit, market, operational, legal, and reputational risks that may arise from CSFTs. The agencies collectively received comments from more than 40 commenters on the Initial Proposed Statement. Although commenters generally supported the Agencies' efforts to describe the types of risk management procedures and internal controls that may help institutions manage the risks associated with CSFTs, virtually all of the commenters recommended changes to the Initial Proposed Statement.

After carefully reviewing the comments on the Initial Proposed Statement, the Agencies issued and requested comment on a Revised Proposed Statement.[5] The Revised Proposed Statement was modified in numerous respects to clarify the purpose, scope and effect of the statement; make the statement more risk-focused and principles based; and focus the statement on those CSFTs that may pose elevated levels of legal or reputational risk to the relevant institution.[6]

## III. Overview of Comments on the Revised Proposed Statement

The Agencies collectively received written comments from 19 commenters on the Revised Proposed Statement, although many commenters submitted identical comments to multiple Agencies. Commenters included banking organizations, financial services trade associations, and individuals. Commenters generally expressed strong support for the Revised Proposed Statement, including its principles-based structure and focus on elevated risk CSFTs. Many commenters also asserted that the Revised Proposed Statement provides a financial institution appropriate flexibility to develop internal controls and risk management procedures that are tailored to the institution's own business activities and organizational structure.

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[4] See 69 FR 28980, May 19, 2004.

[5] See 71 FR 28326, May 16, 2006.

[6] A more detailed summary of the comments on the Initial Proposed Statement, as well as the changes made in response to those comments, is contained in the Federal Register notice accompanying the Revised Proposed Statement (71 FR 28326, 28328-29 (May 16, 2006)).

Several commenters requested that the Agencies clarify or revise the Revised Proposed Statement in certain respects. For example, some commenters asked the Agencies to further streamline the provisions in the statement pertaining to documentation of elevated risk CSFTs, or clarify how the U.S. branches or agencies of foreign banks might implement risk management systems, policies or controls consistent with the statement's principles. In addition, some commenters asked the Agencies to set forth or clarify the legal standards governing the potential liability of financial institutions for CSFTs or provide "safe harbors" from such potential liability. One group of commenters also argued that the Revised Proposed Statement should not be implemented because it allegedly would encourage or condone illegal conduct by financial institutions. The comments received on the Revised Proposed Statement are further discussed below.

## IV. Overview of Final Statement

After carefully reviewing the comments on the Revised Proposed Statement, the Agencies have made minor modifications to the Revised Proposed Statement in response to comments and to clarify the principles, scope, and intent of the Final Statement. The Final Statement has been adopted as supervisory guidance by the Board, OCC, FDIC and OTS and as a policy statement by the SEC. The Agencies will use the Final Statement going forward in reviewing the internal controls and risk management policies, procedures and systems of financial institutions engaged in CSFTs as part of the Agencies' ongoing supervisory process.

The Agencies continue to believe that it is important for a financial institution engaged in CSFTs to have policies and procedures that are designed to allow the institution to effectively manage and address the full range of risks associated with its CSFT activities, including the elevated legal or reputational risks that may arise in connection with certain CSFTs. For this reason, the Final Statement describes the types of risk management principles that the Agencies believe may help a financial institution to identify elevated risk CSFTs and to evaluate, manage, and address these risks within the institution's internal control framework.[7] These policies and procedures should, among other things, be designed to allow the institution to identify elevated risk CSFTs during its transaction and new product approval processes, and should provide for elevated risk CSFTs to be reviewed by appropriate levels of control and management personnel at the institution, including personnel from control areas that are independent of the business line(s) involved in the transaction.

The Final Statement – like the Revised Proposed Statement – applies to financial institutions that are engaged in CSFT activities and focuses on those CSFTs that may create heightened levels of legal or reputational risks for a participating financial institution. Because CSFTs typically are conducted by a limited number of large

[7] As noted in the Final Statement, financial institutions are encouraged to refer to other supervisory guidance and materials prepared by the Agencies for further information concerning market, credit and operational risk, as well as for further information on legal and reputational risk, internal audit and internal controls.

financial institutions, the Final Statement will not affect or apply to the vast majority of financial institutions, including most small institutions.

As the Final Statement recognizes, structured finance transactions encompass a broad array of products with varying levels of complexity. Most structured finance transactions, such as standard public mortgage-backed securities and hedging-type transactions involving "plain vanilla" derivatives or collateralized debt obligations, are familiar to participants in the financial markets, have well-established track records, and typically would not be considered CSFTs for purposes of the Final Statement. Some commenters requested that the Agencies provide a more extensive list of structured finance transactions that typically would not be considered CSFTs. The Agencies note that the types of non-complex transactions listed in the Final Statement are only examples of the types of transactions that typically would not be considered CSFTs and that any list of examples would not, and could not, be all inclusive given the changing nature of the structured finance market. Consistent with the principles-based approach of the Final Statement, the Agencies believe the statement appropriately highlights the hallmarks of a non-complex transaction – i.e., a well established track record and familiarity to participants in the financial markets – that may guide institutions and examiners in considering whether a particular type of transaction should be considered a CSFT now or in the future.

## A. Identification, Due Diligence, and Approval Processes for Elevated Risk CSFTs

As noted above, a financial institution should establish and maintain policies, procedures and systems that are designed to identify elevated risk CSFTs as part of the institution's transaction or new product approval processes, and to ensure that transactions or new products identified as elevated risk CSFTs are subject to heightened review.[8] In general, a financial institution should conduct the level and amount of due diligence for an elevated risk CSFT that is commensurate with the level of risks identified. A financial institution's policies and procedures should provide that CSFTs identified as potentially having elevated legal or reputational risk are reviewed and approved by appropriate levels of management. The Agencies continue to believe that the designated approval process for elevated risk CSFTs should include the institution's representatives from the relevant business line(s) and/or client relationship management, as well as from appropriate control areas that are independent of the business line(s) involved in the transaction. An institution's policies should provide that new complex

[8] In response to comments, the Agencies have modified the Final Statement to clarify that a U.S. branch or agency of a foreign bank is not necessarily expected to establish or adopt separate U.S.-based risk management structures or policies for its CSFT activities. In addition, the Agencies believe the Final Statement provides U.S. branches and agencies of foreign banks sufficient flexibility to develop controls, risk management and reporting structures, and lines of authority that are consistent with the internal management structure of U.S. branches and agencies. However, the risk management structure and policies used by a U.S. branch or agency, whether adopted or implemented on a group-wide or stand-alone basis, should be effective in allowing the branch or agency to manage the risks associated with its CSFT activities.

structured finance products receive the approval of all relevant control areas that are independent of the profit center before the product is offered to customers.[9]

The Final Statement – like the Revised Proposed Statement – provides examples of transactions that may warrant additional scrutiny by an institution. These examples include, among other things, transactions that appear to the institution to:

- Lack economic substance or business purpose;
- Be designed or used primarily for questionable accounting, regulatory, or tax objectives, particularly when the transactions are executed at year-end or at the end of a reporting period for the customer; or
- Raise concerns that the client will report or disclose the transaction in its public filings or financial statements in a manner that is materially misleading or inconsistent with the substance of the transaction or applicable regulatory or accounting requirements.

A few commenters contended that the examples of elevated risk CSFTs contained in the Revised Proposed Statement have characteristics that are signals, if not conclusive proof, of fraudulent activity, and recommended that the Agencies inform financial institutions that transactions or products with any of these characteristics should be considered presumptively prohibited. The commenters also argued that the statement encourages or condones illegal conduct by financial institutions. The Agencies believe that CSFTs that initially appear to an institution, during the ordinary course of its new product or transaction approval process, to have one or more of the characteristics identified in the Final Statement should generally be identified as an elevated risk CSFT, and the institution should conduct due diligence for the transaction that is commensurate with the level of identified, potential risks. The Agencies, however, do not believe it is appropriate to provide that all transactions initially identified as potentially creating elevated legal or reputational risks for an institution should be considered presumptively prohibited. For example, an institution, after conducting additional due diligence for a transaction initially identified as an elevated risk CSFT, may determine that the transaction does not, in fact, have the characteristics that initially triggered the review. Alternatively, the institution may take steps to address the legal or reputational risks that initially triggered the review. In this regard, the Final Statement expressly provides that, if after evaluating an elevated risk CSFT, a financial institution determines that its participation in the transaction would create significant legal or reputational risks for the institution, the financial institution should take appropriate steps to manage and address these risks. Such steps may include modifying the transaction or conditioning the institution's participation in the transaction upon the receipt of representations or

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[9] One commenter sought clarification regarding when during the new product approval process a new complex structured finance product should receive the approval of relevant control areas. The Agencies note that the Final Statement is not intended to prevent institutions from engaging in initial or preliminary discussions or negotiations with potential customers about a new complex structured finance product. However, an institution should obtain the necessary approvals for a new complex structured finance product from appropriate control areas before the institution enters into, or becomes obligated to enter into, a transaction with the customer.

assurances from the customer that reasonably address the heightened risks presented by the transaction.

Importantly, the Final Statement continues to provide that a financial institution should decline to participate in an elevated risk CSFT if, after conducting appropriate due diligence and taking appropriate steps to address the risks from the transaction, the institution determines that the transaction presents unacceptable risks to the institution or would result in a violation of applicable laws, regulations or accounting principles.[10] The Final Statement also expressly notes that financial institutions must conduct their activities in accordance with applicable statutes and regulations. The Agencies believe the Final Statement should assist financial institutions engaged in CSFTs in managing the risks associated with these activities and complying with the law, and does not, as some commenters alleged, encourage or condone illegal conduct.

Some commenters also requested that the Agencies enunciate, clarify or modify the legal standards governing the potential liability of a financial institution for participating in a CSFT that is used for fraudulent or illegal purposes. For example, some commenters asked the Agencies to declare that institutions do not have a duty to ensure the accuracy of a client's public filings or accounting. Other commenters asked that the Agencies state that an institution will not be held liable or responsible for a CSFT if the institution has a reasonable degree of confidence that the customer will report or account for the transactions properly. Other commenters expressed concern that the Revised Proposed Statement, or the comments submitted on that document, attempted to alter the current legal standards under which a financial institution may be held liable for fraudulent activity or criminally responsible under the Federal securities law or other laws.

As events in recent years have highlighted, institutions may in certain circumstances bear significant legal or reputational risk from participating in a CSFT. In light of these risks, the Final Statement describes the types of risk management systems and internal controls that may help a financial institution engaged in CSFTs to identify those CSFTs that may pose heightened legal or reputational risk to the institution, and to evaluate, manage, and address those risks. Because the Final Statement represents guidance on the part of the Banking Agencies and a policy statement on the part of the SEC, it does not, by itself, establish any legally enforceable requirements or obligations. Moreover, as the Final Statement expressly provides, it does not create any private rights of action, nor does it alter or expand the legal duties and obligations that a financial institution may have to a customer, its shareholders or other parties under applicable law.

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[10] Some commenters asked the Agencies to clarify that the Final Statement does not necessarily prevent a financial institution from proceeding with a CSFT simply because there may be some ambiguity in how the transaction might be viewed under the law or applicable accounting principles. The Agencies recognize that in certain circumstances ambiguities may exist as to how the law or accounting principles apply to a CSFT, particularly in light of the inherent complexity and rapidly evolving nature of CSFTs. Nevertheless, as discussed in the Final Statement, a financial institution should maintain strong and effective processes and controls designed to determine whether any such ambiguities may create significant legal or reputational risks for the institution and to manage and address those risks as appropriate.

Accordingly, the Agencies do not believe it is appropriate or possible to address in the Final Statement these legal concerns expressed by commenters.

## B. Documentation

The Final Statement states that a financial institution should create and collect sufficient documentation to, among other things, verify that the institution's policies and procedures related to elevated risk CSFTs are being followed and allow the internal audit function to monitor compliance with those policies and procedures. The Final Statement also provides that, when an institution's policies and procedures require an elevated risk CSFT to be submitted for approval to senior management, the institution should maintain the transaction-related documentation provided to senior management as well as other documentation that reflect management's approval (or disapproval) of the transaction, any conditions imposed by senior management, and the reasons for such action.

Several commenters strongly suggested that the Agencies should eliminate or modify the portions of the statement that provide for a financial institution to maintain certain documentation related to elevated risk CSFTs that are submitted to the institution's senior management for approval (or denial). For example, some commenters argued that institutions should not be required to maintain any documentation for declined transactions. Other commenters expressed concern that this provision was inconsistent with the current practice of financial institutions, would require financial institutions to create new and potentially extensive documentation to memorialize all aspects of the institution's analytical and decision-making process with respect to an elevated risk CSFT, or would require institutions to create or maintain extensive documentation even for transactions that are approved or rejected by junior staff.

As an initial matter, the Agencies note that the Final Statement's provisions regarding documentation for elevated risk CSFTs submitted to senior management for approval (or disapproval) do not apply to transactions that may be reviewed and acted on by more junior personnel in accordance with the institution's policies and procedures. Rather, these provisions apply only to those elevated risk CSFTs that are identified by the institution as potentially involving the greatest degree of risk to the institution and, for this reason, are required to be reviewed by the institution's senior management. The Agencies believe that it is important for institutions to maintain documentation for this category of elevated risk CSFTs, whether approved or declined, that reflects the factors considered by senior management in taking such action. The Agencies believe this type of documentation may be of significant benefit to the institution and to the Agencies in reviewing the effectiveness of the institution's CSFT-related policies, procedures, and internal controls. However, to help address the commenter's concern about potential burden, the Agencies have modified the Final Statement to recognize that the minutes of an institution's reviewing senior management committee may have the information described and to clarify that the documentation for a transaction should reflect the factors considered by senior management in taking action, but does not have to detail every aspect of the institution's legal or business analysis of the transaction.[11]

## C. General Risk Management Principles for Elevated Risk CSFTs

The Final Statement – like the Revised Proposed Statement – also describes some of the other key risk management policies and internal controls that financial institutions should have in place for elevated risk CSFTs. For example, the Final Statement provides that the board of directors and senior management of an institution should establish a "tone at the top" through both actions and formalized policies that sends a strong message throughout the financial institution about the importance of compliance with the law and overall good business ethics. The Final Statement also describes the types of training, reporting mechanisms, and audit procedures that institutions should have in place with respect to elevated risk CSFTs. The Final Statement also provides that a financial institution should conduct periodic independent reviews of its CSFT activities to verify and monitor that its policies and controls relating to elevated risk CSFTs are being implemented effectively and that elevated risk CSFTs are accurately identified and receive proper approvals.

In response to comments, the Agencies have modified the Final Statement to clarify that the independent reviews conducted by a financial institution may be performed by the institution's audit department or an independent compliance function within the institution. One commenter also asked the Agencies to state that the proper role of an institution's independent review function is only to confirm that the institution's policies and procedures for elevated risk CSFTs are being followed and that the function should not assess the quality of the decisions made by institution personnel. The Agencies believe that an institution's audit or compliance department should have the flexibility, in appropriate circumstances, to review the decisions made by institution personnel during the review and approval process for elevated risk CSFTs and for this reason have not made the recommended change.

## V. Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. § 3506; 5 CFR 1320 Appendix A.1), the Agencies reviewed the Final Statement. The Agencies may not conduct or sponsor, and an organization is not required to respond to, this information collection unless it displays a currently valid OMB control number. The Agencies previously determined that certain provisions of the Revised Proposed Statement contained information collection requirements. OMB reviewed and approved the information collections contained in the Revised Proposed Statement for the FDIC, OTS, OCC and SEC; and the Board reviewed the Revised Proposed Statement under the authority delegated to the Board by OMB (5 CFR 1320, Appendix A.1).

[11] In light of comments, the Agencies have modified the Documentation section of the Statement to clarify that an institution should retain sufficient documentation to establish that it has provided the customer any disclosures concerning an elevated risk CSFT that the institution is otherwise required to provide to the customer.

OMB control numbers:

OCC: 1557-0229.
OTS: 1550-0111.
FRB: 7100-0311.
FDIC: 3064-0148.
SEC: 3235-0622.

Burden Estimates

**OCC**

Number of Respondents: 21.
Estimated Time per Response: 25 hours.
Total Estimated Annual Burden: 525 hours.

**OTS**

Number of Respondents: 5.
Estimated Time per Response: 25 hours.
Total Estimated Annual Burden: 125 hours.

**Board**

Number of Respondents: 20.
Estimated Time per Response: 25 hours.
Total Estimated Annual Burden: 500 hours.

**FDIC**

Number of Respondents: 5.
Estimated Time per Response: 25 hours.
Total Estimated Annual Burden: 125 hours.

**SEC**

Number of Respondents: 5.
Estimated Time per Response: 25 hours.
Total Estimated Annual Burden: 125 hours.

No commenters addressed the Agencies' information collection estimates. The Agencies do not believe that the clarifications included in this Final Statement impact the burden estimates previously developed and approved for these information collections. The Agencies have a continuing interest in the public's opinions of our collections of information. At any time, comments regarding the burden estimate, or any other aspect of this collection of information, including suggestions for reducing the burden, may be sent to:

OCC: You should direct your comments to:

Communications Division, Office of the Comptroller of the Currency, Public Information Room, Mailstop 1-5, Attention: 1557-0229, 250 E Street, SW., Washington, DC 20219. In addition, comments may be sent by fax to (202) 874-4448, or by electronic mail to regs.comments@occ.treas.gov. You can inspect and photocopy the comments at the OCC's Public Information Room, 250 E Street, SW., Washington, DC 20219. You can make an appointment to inspect the comments by calling (202) 874-5043. Additionally, you should send a copy of your comments to OCC Desk Officer, 1557-0229, by mail to U.S. Office of Management and Budget, 725 17th Street, NW., #10235, Washington, DC 20503, or by fax to (202) 395-6974.

You can request additional information or a copy of the collection from Mary Gottlieb, OCC Clearance Officer, or Camille Dickerson, (202) 874-5090, Legislative and Regulatory Activities Division, Office of the Comptroller of the Currency, 250 E Street, SW., Washington, DC 20219.

OTS: Information Collection Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552; send a facsimile transmission to (202) 906-6518; or send an e-mail to infocollection.comments@ots.treas.gov. OTS will post comments and the related index on the OTS Internet site at http://www.treas.gov. In addition, interested persons may inspect the comments at the Public Reading Room, 1700 G Street, NW., by appointment. To make an appointment, call (202) 906-5922, send an e-mail to public.info@ots.treas.gov, or send a facsimile transmission to (202) 906-7755.

To obtain a copy of the submission to OMB, contact Marilyn K. Burton at marilyn.burton@ots.treas.gov, (202) 906-6467, or fax number (202) 906-6518, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552

Board: You may submit comments, identified by FR 4022, by any of the following methods:

- Agency Web site: http://www.federalreserve.gov. Follow the instructions for submitting comments at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.
- E-mail: Regs.comments@federalreserve.gov. Include docket number in the subject line of the message.
- Fax: (202) 452-3819 or (202) 452-3102.
- Mail: Michelle Long, Federal Reserve Board Clearance Officer (202) 452-3829, Division of Research and Statistics, Board of Governors of the Federal Reserve System, Washington, DC 20551. Telecommunications Device for the Deaf (TDD) users may contact (202) 263-4869, Board of Governors of the Federal Reserve System, Washington, DC 20551.

All public comments are available from the Board's Web site at http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (20th and C Streets, NW) between 9 a.m. and 5 p.m. on weekdays.

FDIC: Interested parties are invited to submit written comments to the FDIC concerning the Paperwork Reduction Act implications of this proposal. Such comments should refer to "Complex Structured Finance Transactions, 3064-0148." Comments may be submitted by any of the following methods:

- http://www.FDIC.gov/regulations/laws/federal/propose.html.
- E-mail: comments@FDIC.gov. Include Complex Structured Financial Transactions, 3064-0148 in the subject line of the message.
- Mail: Steven F. Hanft (202) 898-3907, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.
- Hand Delivery: Comments may be hand-delivered to the guard station at the rear of the 17th Street Building (located on F Street), on business days between 7 a.m. and 5 p.m.

SEC: You should direct your comments to: Office of Management and Budget, Attention Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 10102, New Executive Office Building, Washington, DC 20503, with a copy sent to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090 with reference to File No. S7-08-06.

The Final Statement follows:

**Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities**

## I. Introduction

Financial markets have grown rapidly over the past decade, and innovations in financial instruments have facilitated the structuring of cash flows and allocation of risk among creditors, borrowers and investors in more efficient ways. Financial derivatives for market and credit risk, asset-backed securities with customized cash flow features, specialized financial conduits that manage pools of assets and other types of structured finance transactions serve important business purposes, such as diversifying risks, allocating cash flows, and reducing cost of capital. As a result, structured finance transactions now are an essential part of U.S. and international capital markets. Financial institutions have played and continue to play an active and important role in the development of structured finance products and markets, including the market for the more complex variations of structured finance products.

When a financial institution participates in a complex structured finance transaction ("CSFT"), it bears the usual market, credit, and operational risks associated with the transaction. In some circumstances, a financial institution also may face heightened legal or reputational risks due to its involvement in a CSFT. For example, in some circumstances, a financial institution may face heightened legal or reputational risk if a customer's regulatory, tax or accounting treatment for a CSFT, or disclosures to investors concerning the CSFT in the customer's public filings or financial statements, do not comply with applicable laws, regulations or accounting principles. Indeed, in some instances, CSFTs have been used to misrepresent a customer's financial condition to investors, regulatory authorities and others. In these situations, investors have been harmed, and financial institutions have incurred significant legal and reputational exposure. In addition to legal risk, reputational risk poses a significant threat to financial institutions because the nature of their business requires them to maintain the confidence of customers, creditors and the general marketplace.

The Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission (the "Agencies") have long expected financial institutions to develop and maintain robust control infrastructures that enable them to identify, evaluate and address the risks associated with their business activities. Financial institutions also must conduct their activities in accordance with applicable statutes and regulations.

## II. Scope and Purpose of Statement

The Agencies are issuing this Statement to describe the types of risk management principles that we believe may help a financial institution to identify CSFTs that may pose heightened legal or reputational risks to the institution ("elevated risk CSFTs") and to evaluate, manage and address these risks within the institution's internal control framework.[12]

Structured finance transactions encompass a broad array of products with varying levels of complexity. Most structured finance transactions, such as standard public mortgage-backed securities transactions, public securitizations of retail credit cards, asset-backed commercial paper conduit transactions, and hedging-type transactions involving "plain vanilla" derivatives and collateralized loan obligations, are familiar to participants in the financial markets, and these vehicles have a well-established track record. These transactions typically would not be considered CSFTs for the purpose of this Statement.

Because this Statement focuses on sound practices related to CSFTs that may create heightened legal or reputational risks – transactions that typically are conducted by a limited number of large financial institutions – it will not affect or apply to the vast majority of financial institutions, including most small institutions. As in all

[12] As used in this Statement, the term "financial institution" or "institution" refers to national banks in the case of the Office of the Comptroller of the Currency; federal and state savings associations and savings and loan holding companies in the case of the Office of Thrift Supervision; state member banks and bank holding companies (other than foreign banking organizations) in the case of the Federal Reserve Board; state nonmember banks in the case of the Federal Deposit Insurance Corporation; and registered broker-dealers and investment advisers in the case of the Securities and Exchange Commission. The U.S. branches and agencies of foreign banks supervised by the Office of the Comptroller, the Federal Reserve Board and the Federal Deposit Insurance Corporation also are considered to be financial institutions for purposes of this Statement.

cases, a financial institution should tailor its internal controls so that they are appropriate in light of the nature, scope, complexity and risks of its activities. Thus, for example, an institution that is actively involved in structuring and offering CSFTs that may create heightened legal or reputational risk for the institution should have a more formalized and detailed control framework than an institution that participates in these types of transactions less frequently. The internal controls and procedures discussed in this Statement are not all inclusive, and, in appropriate circumstances, an institution may find that other controls, policies, or procedures are appropriate in light of its particular CSFT activities.

Because many of the core elements of an effective control infrastructure are the same regardless of the business line involved, this Statement draws heavily on controls and procedures that the Agencies previously have found to be effective in assisting a financial institution to manage and control risks and identifies ways in which these controls and procedures can be effectively applied to elevated risk CSFTs. Although this Statement highlights some of the most significant risks associated with elevated risk CSFTs, it is not intended to present a full exposition of all risks associated with these transactions. Financial institutions are encouraged to refer to other supervisory guidance prepared by the Agencies for further information concerning market, credit, operational, legal and reputational risks as well as internal audit and other appropriate internal controls.

This Statement does not create any private rights of action, and does not alter or expand the legal duties and obligations that a financial institution may have to a customer, its shareholders or other third parties under applicable law. At the same time, adherence to the principles discussed in this Statement would not necessarily insulate a financial institution from regulatory action or any liability the institution may have to third parties under applicable law.

## III. Identification and Review of Elevated Risk Complex Structured Finance Transactions

A financial institution that engages in CSFTs should maintain a set of formal, written, firm-wide policies and procedures that are designed to allow the institution to identify, evaluate, assess, document, and control the full range of credit, market, operational, legal and reputational risks associated with these transactions. These policies may be developed specifically for CSFTs, or included in the set of broader policies governing the institution generally. A financial institution operating in foreign jurisdictions may tailor its policies and procedures as appropriate to account for, and comply with, the applicable laws, regulations and standards of those jurisdictions.[13]

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[13] In the case of U.S. branches and agencies of foreign banks, these policies, including management, review and approval requirements, should be coordinated with the foreign bank's group-wide policies developed in accordance with the rules of the foreign bank's home country supervisor and should be consistent with the foreign bank's overall corporate and management structure as well as its framework for risk management and internal controls.

A financial institution's policies and procedures should establish a clear framework for the review and approval of individual CSFTs. These policies and procedures should set forth the responsibilities of the personnel involved in the origination, structuring, trading, review, approval, documentation, verification, and execution of CSFTs. Financial institutions may find it helpful to incorporate the review of new CSFTs into their existing new product policies. In this regard, a financial institution should define what constitutes a "new" complex structured finance product and establish a control process for the approval of such new products. In determining whether a CSFT is new, a financial institution may consider a variety of factors, including whether it contains structural or pricing variations from existing products, whether the product is targeted at a new class of customers, whether it is designed to address a new need of customers, whether it raises significant new legal, compliance or regulatory issues, and whether it or the manner in which it would be offered would materially deviate from standard market practices. An institution's policies should require new complex structured finance products to receive the approval of all relevant control areas that are independent of the profit center before the product is offered to customers.

**A. Identifying Elevated Risk CSFTs**

As part of its transaction and new product approval controls, a financial institution should establish and maintain policies, procedures and systems to identify elevated risk CSFTs. Because of the potential risks they present to the institution, transactions or new products identified as elevated risk CSFTs should be subject to heightened reviews during the institution's transaction or new product approval processes. Examples of transactions that an institution may determine warrant this additional scrutiny are those that (either individually or collectively) appear to the institution during the ordinary course of its transaction approval or new product approval process to:

- Lack economic substance or business purpose;
- Be designed or used primarily for questionable accounting, regulatory, or tax objectives, particularly when the transactions are executed at year end or at the end of a reporting period for the customer;
- Raise concerns that the client will report or disclose the transaction in its public filings or financial statements in a manner that is materially misleading or inconsistent with the substance of the transaction or applicable regulatory or accounting requirements;
- Involve circular transfers of risk (either between the financial institution and the customer or between the customer and other related parties) that lack economic substance or business purpose;
- Involve oral or undocumented agreements that, when taken into account, would have a material impact on the regulatory, tax, or

accounting treatment of the related transaction, or the client's disclosure obligations;[14]

- Have material economic terms that are inconsistent with market norms (e.g., deep "in the money" options or historic rate rollovers); or
- Provide the financial institution with compensation that appears substantially disproportionate to the services provided or investment made by the financial institution or to the credit, market or operational risk assumed by the institution.

The examples listed previously are provided for illustrative purposes only, and the policies and procedures established by financial institutions may differ in how they seek to identify elevated risk CSFTs. The goal of each institution's policies and procedures, however, should remain the same – to identify those CSFTs that warrant additional scrutiny in the transaction or new product approval process due to concerns regarding legal or reputational risks.

Financial institutions that structure or market, act as an advisor to a customer regarding, or otherwise play a substantial role in a transaction may have more information concerning the customer's business purpose for the transaction and any special accounting, tax or financial disclosure issues raised by the transaction than institutions that play a more limited role. Thus, the ability of a financial institution to identify the risks associated with an elevated risk CSFT may differ depending on its role.

**B. Due Diligence, Approval and Documentation Process for Elevated Risk CSFTs**

Having developed a process to identify elevated risk CSFTs, a financial institution should implement policies and procedures to conduct a heightened level of due diligence for these transactions. The financial institution should design these policies and procedures to allow personnel at an appropriate level to understand and evaluate the potential legal or reputational risks presented by the transaction to the institution and to manage and address any heightened legal or reputational risks ultimately found to exist with the transaction.

Due Diligence. If a CSFT is identified as an elevated risk CSFT, the institution should carefully evaluate and take appropriate steps to address the risks presented by the transaction with a particular focus on those issues identified as potentially creating heightened levels of legal or reputational risk for the institution. In general, a financial institution should conduct the level and amount of due diligence for an elevated risk CSFT that is commensurate with the level of risks identified. A financial institution that structures or markets an elevated risk CSFT to a customer, or that acts as an advisor to a customer or investors concerning an elevated risk CSFT, may have additional responsibilities under the federal securities laws, the Internal Revenue Code, state fiduciary laws or other laws or regulations and, thus, may have greater legal and

[14] This item is not intended to include traditional, non-binding "comfort" letters or assurances provided to financial institutions in the loan process where, for example, the parent of a loan customer states that the customer (i.e., the parent's subsidiary) is an integral and important part of the parent's operations.

reputational risk exposure with respect to an elevated risk CSFT than a financial institution that acts only as a counterparty for the transaction. Accordingly, a financial institution may need to exercise a higher degree of care in conducting its due diligence when the institution structures or markets an elevated risk CSFT or acts as an advisor concerning such a transaction than when the institution plays a more limited role in the transaction.

To appropriately understand and evaluate the potential legal and reputational risks associated with an elevated risk CSFT that a financial institution has identified, the institution may find it useful or necessary to obtain additional information from the customer or to obtain specialized advice from qualified in-house or outside accounting, tax, legal, or other professionals. As with any transaction, an institution should obtain satisfactory responses to its material questions and concerns prior to consummation of a transaction.[15]

In conducting its due diligence for an elevated risk CSFT, a financial institution should independently analyze the potential risks to the institution from both the transaction and the institution's overall relationship with the customer. Institutions should not conclude that a transaction identified as being an elevated risk CSFT involves minimal or manageable risks solely because another financial institution will participate in the transaction or because of the size or sophistication of the customer or counterparty. Moreover, a financial institution should carefully consider whether it would be appropriate to rely on opinions or analyses prepared by or for the customer concerning any significant accounting, tax or legal issues associated with an elevated risk CSFT.

Approval Process. A financial institution's policies and procedures should provide that CSFTs identified as having elevated legal or reputational risk are reviewed and approved by appropriate levels of control and management personnel. The designated approval process for such CSFTs should include representatives from the relevant business line(s) and/or client management, as well as from appropriate control areas that are independent of the business line(s) involved in the transaction. The personnel responsible for approving an elevated risk CSFT on behalf of a financial institution should have sufficient experience, training and stature within the organization to evaluate the legal and reputational risks, as well as the credit, market and operational risks to the institution.

The institution's control framework should have procedures to deliver the necessary or appropriate information to the personnel responsible for reviewing or approving an elevated risk CSFT to allow them to properly perform their duties. Such information may include, for example, the material terms of the transaction, a summary of the institution's relationship with the customer, and a discussion of the significant legal, reputational, credit, market and operational risks presented by the transaction.

[15] Of course, financial institutions also should ensure that their own accounting for transactions complies with applicable accounting standards, consistently applied.

Some institutions have established a senior management committee that is designed to involve experienced business executives and senior representatives from all of the relevant control functions within the financial institution (including such groups as independent risk management, tax, accounting, policy, legal, compliance, and financial control) in the oversight and approval of those elevated risk CSFTs that are identified by the institution's personnel as requiring senior management review and approval due to the potential risks associated with the transactions. While this type of management committee may not be appropriate for all financial institutions, a financial institution should establish processes that assist the institution in consistently managing the review and approval of elevated risk CSFTs on a firm-wide basis.[16]

If, after evaluating an elevated risk CSFT, the financial institution determines that its participation in the CSFT would create significant legal or reputational risks for the institution, the institution should take appropriate steps to address those risks. Such actions may include declining to participate in the transaction, or conditioning its participation upon the receipt of representations or assurances from the customer that reasonably address the heightened legal or reputational risks presented by the transaction. Any representations or assurances provided by a customer should be obtained before a transaction is executed and be received from, or approved by, an appropriate level of the customer's management. A financial institution should decline to participate in an elevated risk CSFT if, after conducting appropriate due diligence and taking appropriate steps to address the risks from the transaction, the institution determines that the transaction presents unacceptable risk to the institution or would result in a violation of applicable laws, regulations or accounting principles.

Documentation. The documentation that financial institutions use to support CSFTs is often highly customized for individual transactions and negotiated with the customer. Careful generation, collection and retention of documents associated with elevated risk CSFTs are important control mechanisms that may help an institution monitor and manage the legal, reputational, operational, market, and credit risks associated with the transactions. In addition, sound documentation practices may help reduce unwarranted exposure to the financial institution's reputation.

A financial institution should create and collect sufficient documentation to allow the institution to:

- Document the material terms of the transaction;
- Enforce the material obligations of the counterparties;
- Confirm that the institution has provided the customer any disclosures concerning the transaction that the institution is otherwise required to provide; and

[16] The control processes that a financial institution establishes for CSFTs should take account of, and be consistent with, any informational barriers established by the institution to manage potential conflicts of interest, insider trading or other concerns.

- Verify that the institution's policies and procedures are being followed and allow the internal audit function to monitor compliance with those policies and procedures.

When an institution's policies and procedures require an elevated risk CSFT to be submitted for approval to senior management, the institution should maintain the transaction-related documentation provided to senior management as well as other documentation, such as minutes of the relevant senior management committee, that reflect senior management's approval (or disapproval) of the transaction, any conditions imposed by senior management, and the factors considered in taking such action. The institution should retain documents created for elevated risk CSFTs in accordance with its record retention policies and procedures as well as applicable statutes and regulations.

## C. Other Risk Management Principles for Elevated Risk CSFTs

General Business Ethics. The board and senior management of a financial institution also should establish a "tone at the top" through both actions and formalized policies that sends a strong message throughout the financial institution about the importance of compliance with the law and overall good business ethics. The board and senior management should strive to create a firm-wide corporate culture that is sensitive to ethical or legal issues as well as the potential risks to the financial institution that may arise from unethical or illegal behavior. This kind of culture coupled with appropriate procedures should reinforce business-line ownership of risk identification, and encourage personnel to move ethical or legal concerns regarding elevated risk CSFTs to appropriate levels of management. In appropriate circumstances, financial institutions may also need to consider implementing mechanisms to protect personnel by permitting the confidential disclosure of concerns.[17] As in other areas of financial institution management, compensation and incentive plans should be structured, in the context of elevated risk CSFTs, so that they provide personnel with appropriate incentives to have due regard for the legal, ethical and reputational risk interests of the institution.

Reporting. A financial institution's policies and procedures should provide for the appropriate levels of management and the board of directors to receive sufficient information and reports concerning the institution's elevated risk CSFTs to perform their oversight functions.

Monitoring Compliance with Internal Policies and Procedures. The events of recent years evidence the need for an effective oversight and review program for elevated risk CSFTs. A financial institution's program should provide for periodic independent reviews of its CSFT activities to verify and monitor that its policies and controls relating to elevated risk CSFTs are being implemented effectively and that

[17] The agencies note that the Sarbanes-Oxley Act of 2002 requires companies listed on a national securities exchange or inter-dealer quotation system of a national securities association to establish procedures that enable employees to submit concerns regarding questionable accounting or auditing matters on a confidential, anonymous basis. See 15 U.S.C. 78j-1(m).

elevated risk CSFTs are accurately identified and received proper approvals. These independent reviews should be performed by appropriately qualified audit, compliance or other personnel in a manner consistent with the institution's overall framework for compliance monitoring, which should include consideration of issues such as the independence of reviewing personnel from the business line. Such monitoring may include more frequent assessments of the risk arising from elevated risk CSFTs, both individually and within the context of the overall customer relationship, and the results of this monitoring should be provided to an appropriate level of management in the financial institution.

Audit. The internal audit department of any financial institution is integral to its defense against fraud, unauthorized risk taking and damage to the financial institution's reputation. The internal audit department of a financial institution should regularly audit the financial institution's adherence to its own control procedures relating to elevated risk CSFTs, and further assess the adequacy of its policies and procedures related to elevated risk CSFTs. Internal audit should periodically validate that business lines and individual employees are complying with the financial institution's standards for elevated risk CSFTs and appropriately identifying any exceptions. This validation should include transaction testing for elevated risk CSFTs.

Training. An institution should identify relevant personnel who may need specialized training regarding CSFTs to be able to effectively perform their oversight and review responsibilities. Appropriate training on the financial institution's policies and procedures for handling elevated risk CSFTs is critical. Financial institution personnel involved in CSFTs should be familiar with the institution's policies and procedures concerning elevated risk CSFTs, including the processes established by the institution for identification and approval of elevated risk CSFTs and new complex structured finance products and for the elevation of concerns regarding transactions or products to appropriate levels of management. Financial institution personnel involved in CSFTs should be trained to identify and properly handle elevated risk CSFTs that may result in a violation of law.

## IV. Conclusion

Structured finance products have become an essential and important part of the U.S. and international capital markets, and financial institutions have played an important role in the development of structured finance markets. In some instances, however, CSFTs have been used to misrepresent a customer's financial condition to investors and others, and financial institutions involved in these transactions have sustained significant legal and reputational harm. In light of the potential legal and reputational risks associated with CSFTs, a financial institution should have effective risk management and internal control systems that are designed to allow the institution to identify elevated risk CSFTs, to evaluate, manage and address the risks arising from such transactions, and to conduct those activities in compliance with applicable law.

Dated:  December 12, 2006.

John C. Dugan (signed)
John C. Dugan,
Comptroller of the Currency.

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Dated:  December 21, 2006.

Scott M. Polakoff (signed)
By the Office of Thrift Supervision.
Scott M. Polakoff,
Deputy Director & Chief Operating Officer

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By order of the Board of Governors of the Federal Reserve System, December 20, 2006.

Jennifer J. Johnson (signed)
Jennifer J. Johnson,
Secretary of the Board.

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Dated at Washington, DC, the 22nd day of December, 2006.

Robert E. Feldman (signed)
By order of the Federal Deposit Insurance Corporation.
Robert E. Feldman,
Executive Secretary.

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Dated: January 5, 2007

Nancy M. Morris (signed)
By the Securities and Exchange Commission
Nancy M. Morris
Secretary