Office of the Comptroller of the Currency

Board of Governors of the Federal Reserve System

Interpretive Letter #1091
December 2007
12 CFR 3

August 17, 2006

Dear **[ ]**:

This letter is in response to your June 1, 2006 letter on behalf of **[ ]** (the Bank), and its parent, **[ ]** (the Bank Holding Company), in which you request a risk-based capital interpretation for a proposed synthetic securitization of a static pool of home equity lines of credit (HELOCs) and closed-end home equity loans originated and serviced by the Bank and owned by the Bank or a subsidiary (the Reference Assets). The risk-based capital treatment you proposed is based upon the November 15, 1999 Joint Agency Guidance on Synthetic Collateralized Loan Obligations (Joint Agency Guidance),[1] the November 29, 2001 final rule entitled "Capital Treatment of Recourse, Direct Credit Substitutes and Residual Interests in Asset Securitizations" (Final Rule),[2] the Office of the Comptroller of the Currency's (OCC) Interpretative Letters # 945 (November 2002) and #988 (April 2004),[3] and the Federal Reserve Board's (FRB) July 14, 2005 letter relating to a proposed synthetic securitization of margin loans. The risk-based capital treatment that should be applied to the proposed transaction is described below and is conditional upon the Bank satisfying the risk management and disclosure conditions detailed in the annex to the Joint Agency Guidance as amended by Interpretative Letter #988.

Description of the Transaction

In this synthetic securitization, the Bank will select and isolate the Reference Assets into a Reference Portfolio, and the Reference Assets will remain on the Bank's balance sheet. The credit risk of the Reference Portfolio will be stratified into notional segments or tranches that are expected to consist of an unrated equity position and rated subordinated, mezzanine, and senior positions. The Bank will retain the risks of the equity, subordinated, and senior positions. The retained equity position will not be externally rated. The retained subordinated positions will be externally rated B- through BB+ and the retained senior positions will be externally rated AA- and above. The mezzanine positions on which the Bank will purchase credit protection will be

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[1] OCC Bulletin 99-43, Federal Reserve Board SR Letter 99-32.
[2] 66 Fed. Reg. 59614 (November 29, 2001).
[3] The Federal Reserve Board was a signatory to Interpretative Letter #988.

externally rated BBB- through A+. The Bank will obtain external ratings from at least two nationally recognized statistical rating organizations on the non-traded subordinated and senior positions, and the ratings will be publicly available.

The Bank will purchase credit protection on the mezzanine tranches through a credit default swap. The credit default swap counterparty (Issuer) will in turn issue credit-linked notes to third-party investors referencing the mezzanine tranches of the Reference Portfolio. Over the life of the transaction, the Issuer may invest the proceeds in a money market deposit account maintained by the Issuer at the Bank, U.S. Treasury securities, debt obligations of U.S. government-sponsored entities, or deposits or other debt obligations of banks in the United States or other OECD countries (Eligible Investments). The initial Eligible Investment is expected to be a money market deposit account maintained by the Issuer at the Bank that would be pledged to secure both the Issuer's obligations to the Bank under the credit default swap and to the investors under the credit-linked notes.

The Bank will pay a monthly fee to the Issuer for the credit protection provided under the credit default swap. The amount of that fee is determined monthly so that when the fee is added to the income to be received by the Issuer on the Eligible Investments, the Issuer would have sufficient funds to pay its ordinary expenses including the interest on the credit-linked notes. The variability of the fee is not dependent on the credit quality of or the return on the Reference Portfolio's underlying exposures, but instead on the level of income generated by the Eligible Investments.

The credit default swap purchased by the Bank will have a maturity of five years. The credit default swap will terminate early if the outstanding amount of the credit-linked notes is equal to zero or (1) the Bank has a short term debt rating below A-1/P-1/F-1/R-1 or a long term debt rating below A/A2/A/A as rated by Standard & Poors Rating Service, Moody's Investors Service, Inc., Fitch Ratings, or Dominion Bond Ratings Service, Inc., respectively, and (2) the Bank fails to deliver collateral to the Issuer or obtain a third-party guarantee on its payment obligations to the Issuer. The early termination provision is not, directly or indirectly, contingent upon the credit quality of the Reference Portfolio's underlying exposures. Additionally, the Bank may terminate the credit default swap early if any financial accounting, tax, banking, insurance or regulatory requirements occur resulting in an adverse impact to the Bank.

Since the Reference Assets include HELOCs, the principal balance of the Reference Portfolio could increase or decrease when compared to the principal balance as of the closing date of the transaction. The credit protection obtained by the Bank, however, will not exceed the notional amount of the credit-linked notes sold to the investors. The Bank will consider any amount of the outstanding balance of the Reference Portfolio that exceeds the closing date balance outside of the scope of the synthetic securitization and subject to the full 8 percent risk-based capital charge. Net principal collections, i.e., principal collections that exceed new draws, and any losses on the Reference Assets will be allocated between the synthetic securitization and the Bank according to the Current Balance Ratio. The Current Balance Ratio is calculated monthly and is equal to the lesser of (a) 1.00 or (b) the outstanding amount of all tranches of the securitization at the beginning of the period divided by the principal balance of the Reference Assets at the beginning of the period. Repayments of principal on the Reference Assets allocated to the securitization according to the Current Balance Ratio will be applied to reduce the size of the securitization tranches in the order of seniority, i.e., from most senior to most junior. Any losses on the Reference Assets allocated to the securitization according to the Current Balance Ratio will be absorbed by the securitization tranches in the reverse order of seniority, i.e., from most junior to most senior. The Bank will absorb any losses on the Reference Assets not allocated to the securitization.

The Bank may not add any additional assets to the Reference Portfolio, but may remove certain assets for which credit quality has not deteriorated. Any asset that is thirty or more days delinquent, in the process of foreclosure or in default may not be removed from the Reference Portfolio.

Risk-Based Capital Treatment

The Current Balance Ratio provides for a pro rata sharing of losses on the Reference Assets between the synthetic securitization and the Bank when the outstanding balance of those assets exceeds the notional amount of the synthetic securitization. The Bank should treat any portion of the Reference Assets considered outside of the synthetic securitization as an unprotected, on-balance sheet asset and risk weight it accordingly. The Bank will fully absorb any losses allocated to that portion of the Reference Asset outside of the synthetic securitization.

The synthetic securitization described in this letter qualifies for a risk-based capital approach based on the principles established in the Joint Agency Guidance, the Final Rule, and Interpretative Letter #988. The Bank must hold dollar-for-dollar capital against the retained, unrated equity position. As long as the external ratings of the retained subordinated and senior positions comply with the requirements of the Final Rule[4] the Bank may use the ratings-based approach to determine its risk-based capital requirement for those positions. To comply with the Final Rule, the Bank must obtain publicly available external ratings from at least two nationally recognized statistical rating organizations, and the ratings must be based on the same criteria used to rate traded positions. If the external ratings meet these criteria, the Bank must hold dollar-for-dollar capital for the retained B-rated subordinated position, must apply a 200 percent risk-weight to the retained BB-rated position, and may apply a 20 percent risk weight to the retained AA and AAA positions.

The Bank may recognize the credit protection obtained via the credit default swap on the mezzanine tranches as long as the Eligible Investments pledged to secure the Issuer's obligation under that credit default swap qualify for collateral recognition under the OCC and FRB's risk-based capital rules.[5] Specifically, if the Eligible Investments are a money market deposit account maintained by the Issuer at the Bank or U.S. Treasury securities, the Bank may assign a risk weight of zero percent to the face amount of the mezzanine tranches. If the Eligible Investments consist of debt obligations of U.S. government-sponsored entities, the Bank may assign a risk weight of 20 percent to the face amount of the mezzanine tranches. However, if the Eligible Investments are deposits or other debt obligations of banks in the United States or other

[4] 12 CFR 3, Appendix A Section 4(d) (OCC); 12 CFR parts 208 and 225, Appendix A, Section III.B.3.c.ii (FRB)
[5] 12 CFR 3, Appendix A Section 3(a)(1)(viii) and Section 3(a)(2)(viii) (OCC); 12 CFR parts 208 and 225, Appendix A, Sections III.C.1 and III.C.2 (FRB).

OECD countries, the Bank may not recognize any benefit from the credit default swap and must assign a risk weight of 100 percent to the face amount of the mezzanine tranches.

Since the five-year maturity of the synthetic securitization is shorter than that of the Reference Assets, the Bank may recognize only a portion of the credit protection obtained during the last year of the transaction and apply the reduced risk weights to only a portion of the mezzanine and retained senior tranches so that during the last quarter prior to maturity of the transaction the Bank will hold risk-based capital for the Reference Assets as if it had purchased no credit protection. The approach for adjusting the risk-based capital charge on the Reference Assets is based upon OCC Interpretative Letter #945 and the FRB's July 14, 2005 letter.

For example, if the transaction matured on June 30, 2011, the amortization approach described below would begin on July 1, 2010. In that quarter, the Bank may consider only 75 percent of the outstanding notional amount of the mezzanine tranches as protected by the credit default swap and eligible for a reduced risk-based capital charge. Additionally, only 75 percent of the outstanding senior tranche may receive the reduced risk weight based on its external rating. The remaining 25 percent of the outstanding notional amount of the mezzanine and senior tranches would receive the risk-based capital charge appropriate for the Reference Assets without recognition of any credit protection or external rating, respectively. During the third quarter prior to maturity, or starting October 1, 2010 in the example, the Bank may consider only 50 percent of the outstanding notional amount of the mezzanine tranches as protected by the credit default swap and only 50 percent of the retained senior tranches as rated. The Bank must consider the remaining 50 percent of each tranche as unprotected or unrated, as appropriate. During the second quarter prior to maturity, or starting January 1, 2011 in the example, the Bank may consider only 25 percent of the outstanding notional amount of the mezzanine tranches as protected by the credit default swap and only 25 percent of the retained senior tranches as rated. The Bank must consider the remaining 75 percent as unprotected or unrated. During the last quarter of the transaction, or starting April 1, 2011, the Bank must hold risk-based capital on the outstanding balance of the Reference Assets using the full 100 percent risk weight.

During the amortization period described above, the Bank would continue to hold dollar-for-dollar capital against the unrated equity position and the B-rated subordinated tranche and would assign a 200 percent risk weight to the BB-rated subordinated tranche. The OCC and FRB recognize that applying the approach described above could result in a total risk-based capital requirement on the Reference Assets larger than 8 percent of the outstanding balance of the Reference Assets. Notwithstanding, the maximum risk-based capital charge on the Reference Assets during this amortization period would be 8 percent.

The risk-based capital treatment described above is conditional upon the Bank satisfying the risk management and disclosure conditions detailed in the annex to the Joint Agency Guidance as amended by Interpretative Letter #988.

Conclusion

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

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

Sincerely,

/s/	*/s/*
Tommy Snow Director, Capital Policy Comptroller of the Currency	Barbara Bouchard Deputy Associate Director Federal Reserve Board