

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

12 CFR Part 567

[No. 95-159]

RIN 1550-AA81

**Risk-Based Capital Requirements
Transfer of Assets With Recourse**AGENCY: Office of Thrift Supervision,
Treasury.ACTION: Interim rule with request for
comment.

SUMMARY: The Office of Thrift Supervision (OTS) is amending its risk-based capital standards as required by sections 208 and 350 of the Riegle Community Development and Regulatory Improvement Act of 1994 (the Riegle Act).

Section 208 of the Riegle Act is intended to facilitate the origination and sale of small business loans and leases of personal property by providing a more favorable risk-based capital treatment for transfers of such loans and leases with recourse. The OTS is amending 12 CFR Part 567 to permit qualifying institutions to elect to use this more favorable capital treatment.

Because the OTS capital rules already incorporate the requirements of section 350 of the Riegle Act, the agency does not propose regulatory revisions implementing this provision.

DATES: The interim rule is effective August 31, 1995. Comments on this interim rule must be received by October 30, 1995.

ADDRESSES: Written comments should be submitted to Chief, Dissemination Branch, Office of Thrift Supervision, 1700 G Street NW., Washington, DC 20552, Attention: Docket No. 95-159. These submissions may be hand delivered to 1700 G Street NW., from 9:00 a.m. to 5:00 p.m. on business days; they may be sent by facsimile transmission to FAX number (202) 906-7755. Comments will be available for inspection at 1700 G Street NW., from 1:00 p.m. until 4:00 p.m., on business days.

FOR FURTHER INFORMATION CONTACT: John F. Connolly, Senior Program Manager for Capital Policy (202/906-6465), Supervision; or Karen Osterloh, Counsel, Banking and Finance (202/906-6639), Regulations and Legislation Division, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

SUPPLEMENTARY INFORMATION:

I. Background

The OTS is amending its risk-based capital requirements, as necessary, to implement sections 208 and 350 of the Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. 103-325, 108 Stat 2160 (Riegle Act). These sections address the treatment of recourse obligations under the risk-based capital rules. A recourse obligation arises, for example, when a savings association transfers a loan or mortgage-related security subject to an agreement to repurchase or replace the loan or security if the underlying borrower defaults.

The Office of the Comptroller of the Currency, the Federal Reserve Board and the Federal Deposit Insurance Corporation¹ are also in the process of developing and issuing rules implementing sections 208 and 350 of the Riegle Act.

II. Current Treatment of Recourse Obligations Under OTS Risk-Based Capital Regulations

Under current OTS risk-based capital regulations, the full value of assets sold with recourse must be included in total assets and multiplied by the appropriate risk-weight percentage. Savings associations are required to hold capital equal to 8 percent of the risk-weighted value of the assets sold.²

However, an alternative rule (commonly called the "low-level recourse rule") applies whenever the foregoing requirements would result in a capital charge greater than the savings association's maximum recourse liability on the assets sold. Under these circumstances, instead of including the assets sold in an association's risk-weighted assets, the savings association's risk-based capital requirement is simply increased by an amount equal to the association's maximum recourse liability.³

Additionally, if the association is required under generally accepted accounting principles (GAAP) to establish a recourse liability account to absorb estimated probable losses from the recourse obligation, the amount of capital required is reduced.⁴ When the low-level recourse rule applies, the amount of the recourse obligation would be deducted from the maximum contractual obligation. When the low-level recourse rule does not apply, the amount of the recourse liability account

would be deducted from the amount of the transferred assets.

The following example illustrates how the foregoing rules work. If an association transfers a \$1,000 pool of small business loans with unlimited recourse, it would be required to hold capital equal to 8 percent of \$1,000 (an \$80 capital charge). However, if the association limits its maximum contractual recourse obligation to \$30, the capital requirement would be limited to \$30 under the low-level recourse rule. Moreover, if the association is required to establish a recourse liability account of \$10 under GAAP, the capital charge would be reduced to \$20.

III. Section 350 of the Riegle Act

Section 350(b)(1) of the Riegle Act provides that "[t]he amount of risk-based capital required to be maintained, under regulations prescribed by the appropriate Federal banking agency, by any insured depository institution with respect to assets transferred with recourse by such institution may not exceed the maximum amount of recourse for which such institution is contractually liable under the recourse agreement." The OTS capital rule, described above, already incorporates this "low-level recourse" approach at 12 CFR 567.6(a)(2)(i)(C).

Section 350(b)(2) permits the OTS to impose a higher capital charge if it determines that a higher capital requirement is necessary for the savings association's safety and soundness. Consistent with this section, the OTS has retained the authority to increase this capital charge under appropriate circumstances.⁵

Accordingly, the OTS has determined that it does not need to take further action to implement section 350 of the Riegle Act.

The OTS, however, solicits comment on its current approach for factoring associations' capital requirements under the low-level recourse approach into their total risk-based capital ratio and Tier 1 (core) risk-based capital ratio. The numerator in these ratios is the actual amount of risk-based or core capital, respectively, held by an association. The denominator is the total risk-weighted assets held by an association. These ratios are used to assess associations' capital positions and to determine capital categories for purposes of the prompt corrective action (PCA) provisions of section 38(b) of the Federal Deposit Insurance Act. 12 U.S.C. 1831o.⁶ As OTS regulations are

¹ These agencies with the OTS are collectively referred to as "the Banking Agencies."

² 12 CFR 567.6(a)(2)(i)(C).

³ 12 CFR 567.6(a)(2)(i)(C).

⁴ 59 FR 27116, 27122, n.17 (May 25, 1994).

⁵ 12 CFR 567.3.

⁶ See 12 CFR Part 565.

currently worded, an association that utilizes the low-level recourse rule merely adds the amount of its maximum contractual recourse obligation to its capital requirement. Furthermore, the amount of assets sold subject to the low-level recourse is not included in the association's total risk-weighted assets. Thus, when the aforementioned capital ratios under the PCA provisions are computed, adjustments must be made to ensure that the ratios take into account a savings association's low-level recourse exposure.

The OTS currently permits associations to use the more favorable of two adjustment computations. A savings association may either: (1) Deduct its aggregate low-level recourse capital requirement from the capital amount (*i.e.*, the numerator) in calculating these ratios; or (2) add its low-level recourse capital requirement multiplied by 12.5 (*i.e.*, the reciprocal of the 8 percent capital requirement) to its risk-weighted assets (*i.e.*, the denominator) in calculating the ratios. These alternative methods for calculating an association's Tier 1 risk-based capital ratio and total risk-based capital ratio are set forth in Appendix B to section 120, "Capital Adequacy," of the OTS Regulatory Handbook: Thrift Activities (January, 1994). The Banking Agencies are considering other alternatives including requiring all institutions to follow option (2) described above. The OTS specifically requests comment on this approach.

IV. Section 208 of the Riegle Act

Section 208 of the Riegle Act prescribes accounting principles and establishes modified capital rules for transfers of small business loans and leases of personal property with recourse (small business obligations) by qualified insured depository institutions. The term "small business" means a business that meets the criteria for a small business concern established by the Small Business Administration under section 3(a) of the Small Business Act.⁷ Under section 208(c), an insured depository institution is a qualified institution, if it: (1) Is well capitalized for PCA purposes, or (2) is adequately capitalized for PCA purposes and has obtained approval to apply the modified capital rules from the appropriate Federal banking agency.⁸ The OTS solicits comments on how it should

determine whether an adequately capitalized association should be permitted to use the modified capital rule under section 208.

Under section 208(a), accounting principles applicable to the transfer of a small business loan or lease of personal property with recourse and contained in reports or statements required to be filed with the appropriate Federal banking agency by a qualified insured depository institution, must be consistent with GAAP. The OTS currently requires savings associations to comply with GAAP in their financial reports and statements, including the reporting of transfers of assets with recourse.⁹ Accordingly, no regulatory amendments are required to implement section 208(a).

Section 208(b) prescribes modified risk-based capital requirements for transfers of small business loans or leases of personal property with recourse that are sales under GAAP. This modified risk-based capital treatment permits a qualified insured depository institution to include in its risk-weighted assets, for the purposes of applicable capital standards and other capital measures, only the amount of the retained recourse multiplied by the appropriate risk-weight percentage. For example, if an association sold a \$1,000 pool of small business loans with recourse, but limited its recourse liability to the first \$100 dollars of loss on the pool, section 208(b) would limit the applicable capital charge to \$8.00 (8 percent of the \$100 of retained recourse).

By contrast, current OTS risk-based capital regulations require savings associations to include in risk-weighted assets the full value of assets transferred with recourse multiplied by the appropriate risk-weight percentage. If the current rule were applied to the foregoing example, the association's capital charge would be 8 percent of the \$1,000 pool of transferred assets resulting in an \$80 capital charge, rather than the \$8.00 capital charge under section 208(b).

To be eligible for the preferential capital treatment under section 208(b), a qualified institution must "establish and maintain a reserve equal to an amount sufficient to meet the reasonable estimated liability of the institution under the recourse arrangement." The OTS capital rule follows GAAP in determining when to treat transfers with recourse as sales and how those sales must be accounted for. Accordingly, the OTS already requires transferors of assets with recourse to accrue, as a

separate liability, an amount sufficient to absorb their estimated probable losses under the recourse provision for the life of the assets transferred.

Section 208(d) limits the aggregate amount of recourse that may be retained by a qualified insured depository institution with respect to transactions that are accorded the modified capital treatment. Under this provision, the total outstanding amount of recourse retained by the institution and accorded the modified capital treatment may not exceed 15 percent of the association's risk-based capital or such greater amount as may be established by the appropriate Federal banking agency by regulation or order. The rule sets the limit under section 208(d) at 15 percent of the association's total capital under 12 CFR 567.5(c)(4).

Furthermore, section 208(e) provides that if an institution exceeds the aggregate limit or if it loses its qualified status, transactions completed while the institution was qualified continue to receive the favorable capital treatment. This provision is incorporated in the rule at 12 CFR 567.6(a)(3)(iv).

Section 208 contains two provisions that permit the agency, by regulation, to modify the requirements specified in the statute. As noted above, section 208(d)(2) permits the agency to increase the 15 percent aggregate limit. In addition, section 208(h) authorizes the OTS to establish an alternative system governing the amount of capital and reserves for small business obligations. The OTS has elected not to implement these discretionary alternative provisions at this time.

Section 208(f) states, "The capital of an insured depository institution shall be computed without regard [to section 208] in determining whether the institution is adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized under section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o)." Section 1831o addresses prompt corrective action.

The caption to section 208(f), "Prompt Corrective Action Not Affected," and the legislative history indicate that section 208 was not intended to affect the prompt corrective action system.¹⁰ However, the statute does not include "well capitalized" in the list of capital categories not affected.

The prompt corrective action system deals primarily with imposing corrective sanctions on associations that are less than adequately capitalized. Therefore, allowing an association that

⁷ See 15 U.S.C. 632(a) and 13 CFR Part 121 (1995).

⁸ See Section 208(i)(1) and (7). Determinations as to whether a savings association is a qualified institution are made without regard to the accounting principles or capital requirements set forth in section 208(a) and (b). See Section 208(c).

⁹ 12 CFR 562.2(b)(1995).

¹⁰ See S. Rep. No. 103-169, 103d Cong., 1st Sess. 38, 69 (1993).

is adequately capitalized without section 208¹¹ to use the modified capital treatment under section 208 for purposes of determining whether it is well capitalized generally would not affect the application of the prompt corrective action sanctions to the association. Other statutes and regulations treat an association more favorably if it is well capitalized (as defined under the prompt corrective action statute), but these provisions are not part of the prompt corrective action system of sanctions. Permitting an association be treated as well capitalized for purposes of these other provisions also will not affect the imposition of prompt corrective action sanctions.

There is one provision of the prompt corrective action system that could be affected by treating an association as well capitalized, rather than adequately capitalized. If the OTS determines that an association is in an unsafe or unsound condition or is engaging in an unsafe or unsound practice, section 1831o(g) authorizes the OTS—(1) to reclassify a well capitalized association as adequately capitalized, and (2) to require an adequately capitalized association to comply with certain prompt corrective action provisions as if the association were undercapitalized. Because the text and legislative history of section 208 clearly indicate that Congress did not intend to affect prompt corrective action, the OTS believes that section 208 does not affect the capital calculation for purposes of section 1831o(g), regardless of the association's capital level.

Thus, an association may use the capital treatment described in section 208 when determining whether it is well capitalized for purposes of prompt corrective action (except 12 U.S.C. 1831o(g)), as well as for other regulations that reference the well capitalized capital category.¹² An association may not use the capital treatment described in section 208 when determining whether it is adequately capitalized, undercapitalized,

significantly undercapitalized, or critically undercapitalized for purposes of prompt corrective action or other regulations that directly or indirectly reference the prompt corrective action capital categories.¹³ No association may use the capital treatment under section 208 for purposes of 12 U.S.C. 1831o(g). The following is a summary of the applicable rules:

(1) *Associations that are well capitalized without using section 208.* These associations are "qualifying" and may apply section 208 to any transfers of small business obligations with recourse (up to the 15% of capital limit), for all purposes except 12 U.S.C. 1830o(g).

(2) *Associations that are adequately capitalized without using section 208, but have written permission from the OTS to use section 208.* These associations are also "qualifying" and may apply section 208 to any transfers of small business obligations with recourse (up to the 15% of capital limit), for all purposes except 12 U.S.C. 1830o(g).

(3) *All other associations.* Other types of associations are not "qualifying" and cannot apply section 208 to new obligations. However, if the association qualified in the past, it may continue to apply section 208 to obligations arising out of transfers that occurred while the association was qualified, for purposes of determining capital under Part 567.¹⁴ However, section 208 may not be used by these associations for purposes of prompt corrective action or other regulations that directly or indirectly reference prompt corrective action capital categories.

The OTS will not object if an association decides to apply the capital treatment described in this rule as of March 22, 1995, because this is the date by which the regulatory changes prescribed by the Riegle Act were to have become effective.

The OTS solicits comment on all aspects of this rule and any other issues related to its implementation of sections 208 and 350.

The Banking Agencies are in the process of reviewing other regulations and written policies relating to transfers

of assets with recourse. They intend to make comprehensive revisions of their regulations and written policies addressing the exposure of insured depository institutions to credit risk from transfers of assets with recourse. A notice of proposed rulemaking and advance notice of proposed rulemaking were published in the **Federal Register** on May 25, 1994.¹⁵ The Banking Agencies are working together on this rulemaking and intend to take further action as quickly as feasible.

V. Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act, the OTS hereby certifies that this interim rule will not have a significant economic impact on a substantial number of small entities. The changes are required by statute and will not affect savings associations' risk-based capital for prompt corrective actions purposes. Accordingly, a regulatory flexibility analysis is not required.

VI. Executive Order 12866

The OTS has determined that this interim rule is not a significant regulatory action as defined in Executive Order 12866. Under the interim rule, some associations' measured risk-based capital ratios may improve. This change, however, should have no material effect on the safety and soundness of affected associations and will not affect their measured risk-based capital for prompt corrective action purposes.

VII. Unfunded Mandates Reform Act of 1995

Section 202 of the Unfunded Mandates Reform Act of 1995, 104 Pub. L. 104-4 (signed into law on March 22, 1995), requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in expenditure by State, local, and tribal governments, in the aggregate, or by the private sector of \$100 million or more in one year. If the budgetary impact statement is required, section 205 of the Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. As discussed in the preamble, the interim rule authorizes an alternative method of calculating capital that permits savings associations to elect to hold less capital for certain recourse obligations. The OTS has therefore determined that the interim rule will not result in expenditure by State, local, or tribal governments or by the private

¹¹ It is very unlikely, but theoretically possible that an association that is undercapitalized without section 208 would become well capitalized if it applied the modified capital treatment under section 208. Because section 208 was not intended to affect prompt corrective action and because allowing an undercapitalized association to become well capitalized would affect prompt corrective action, the OTS believes that section 208 does not allow an undercapitalized association to use the modified capital treatment to become well capitalized for the purposes of prompt corrective action.

¹² An association that is subject to a written agreement or capital directive as discussed in the OTS's prompt corrective action regulation would not be considered to be well capitalized.

¹³ Under section 208, the capital calculation used to determine whether an association is well capitalized differs from the calculation used to determine whether an association is adequately capitalized. As a result, it is possible that an institution could be well capitalized using one calculation and adequately capitalized using the other. In this situation, the institution would be considered well capitalized.

¹⁴ E.g., 12 CFR 567.2 (minimum capital requirements) and other regulations keyed to the OTS minimum capital requirements rather than the prompt corrective action categories.

¹⁵ See 59 FR 27116 (May 25, 1994).

sector of more than \$100 million. Accordingly, sections 202 and 205 do not apply.

VIII. Paperwork Reduction Act and Regulatory Burden

The OTS has determined that this interim rule will not increase the regulatory paperwork burden on savings associations under the Paperwork Reduction Act of 1980 (44 U.S.C. 3501 *et seq.*). Consequently, no information has been submitted to the Office of Management and Budget for review.

Section 302 of the Riegle Act requires that new regulations and amendments to regulations that impose additional reporting, disclosures, or other new requirements take effect on the first date of the calendar quarter following publication of the rule unless, among other things, the agency determines, for good cause, that the regulations should become effective on a day other than the first day of the next quarter. The OTS believes that an immediate effective date is appropriate since the interim rule relieves a regulatory burden on qualifying savings associations that transfer small business obligations with recourse by significantly reducing the capital requirements on such obligations. This immediate effective date will permit qualifying institutions to reduce the amount of capital they must maintain to support the risk retained in these transfers. Moreover, the OTS does not anticipate that the immediate application of the rules will present a hardship to institutions in terms of compliance. Also, there is a statutory requirement for the OTS to promulgate final regulations implementing the provisions of section 208 by March 22, 1995. For these reasons, the OTS has determined that this effective date is appropriate.

IX. Administrative Procedure Act

Section 208(g) of the Riegle Act requires that the OTS promulgate final rules implementing section 208 no later than March 22, 1995. The OTS has determined that the notice and public participation that are ordinarily required by the Administrative Procedure Act (5 U.S.C. 553) (the APA) before a regulation may take effect would, in this case, be impracticable due to the time constraints imposed by section 208(g). In addition, advance public notice and comment is unnecessary because the interim rule substantially restates the provisions of the statute. Further, the interim rule would permit qualifying institutions to reduce their capital levels, thereby providing these institutions with greater lending flexibility. Consequently, the

added delay that would result from seeking advance notice and public participation could potentially adversely impact credit availability.

Section 553(d) of the APA permits the waiver of the 30-day delayed effective date requirement for good cause, or where a rule relieves a restriction. The OTS believes that the limitations of time and the potential loss of benefit to affected parties during the pendency of this rulemaking constitutes good cause to waive the 30-day delayed effective date requirement. The OTS further believes that the 30-day effective date may be waived because the rule relieves a restriction. Accordingly, the interim rule will be immediately effective upon publication in the **Federal Register**. Nevertheless, the OTS seeks the benefit of public comment before adopting a final rule on this subject. Accordingly, the OTS invites interested persons to submit comments during the 60-day comment period. The OTS will revise the interim rule as appropriate based on these comments.

List of Subjects in 12 CFR Part 567

Capital, Reporting and recordkeeping requirements, Savings associations.

For the reasons set forth in the preamble, the Office of Thrift Supervision hereby amends Part 567, chapter V, title 12, Code of Federal Regulation as set forth below:

Subchapter D—Regulations Applicable to All Savings Associations

PART 567—CAPITAL

1. The authority citation for part 567 is revised to read as follows:

Authority: 12 U.S.C. 1462, 1462a, 1463, 1464, 1467a, 1835, 1848 (note), 4808.

2. Section 567.6(a) is revised by adding a fourth and fifth sentence between the phrase “recourse servicing’.” and the parenthetical in (a)(2)(i)(C), and by adding a new paragraph (a)(3) to read as follows:

§ 567.6 Risk-based capital credit risk-weight categories.

- (a) * * *
- (2) * * *
- (i) * * *

(C) * * * This category also includes transfers of small business loans or leases of personal property with recourse. Such transfers, however, may be subject to the alternative capital computation set forth in paragraph (a)(3) of this section. * * *

(3) *Alternative capital computation for small business obligations—* (i) *Definitions.* For the purposes of this paragraph (a)(3):

(A) *Qualified savings association* means a savings association that:

(1) Is well capitalized as defined in 12 CFR 565.4 without applying the capital treatment described in paragraph (a)(3)(ii) of this section; or

(2) Is adequately capitalized as defined in 12 CFR 565.4 without applying the capital treatment described in paragraph (a)(3)(ii) of this section and has received written permission from the OTS to apply that capital calculation.

(B) *Small business* means a business that meets the criteria for a small business concern established by the Small Business Administration in 12 CFR 121 pursuant to 15 U.S.C. 632.

(ii) *Capital requirement.* With respect to a transfer of a small business loan or lease of personal property with recourse that is a sale under generally accepted accounting principles, a qualified savings association may elect to include only the amount of its retained recourse in its risk-weighted assets for the purposes of paragraph (a)(2)(i)(C) of this section. To qualify for this election, the savings association must establish and maintain a reserve under generally accepted accounting principles sufficient to meet the reasonable estimated liability of the savings association under the recourse arrangement.

(iii) *Aggregate amount of recourse.* The total outstanding amount of recourse retained by a qualified savings association with respect to transfers of small business loans and leases of personal property and included in the risk-weighted assets of the savings association as described in paragraph (a)(3)(ii) of this section, may not exceed 15 percent of the association’s total capital computed under § 567.5(c)(4).

(iv) *Savings association that ceases to be a qualified savings association or that exceeds aggregate limits.* If a savings association ceases to be a qualified savings association or exceeds the aggregate limit described in paragraph (a)(3)(iii) of this section, the savings association may continue to apply the capital treatment described in paragraph (a)(3)(ii) of this section to transfers of small business loans and leases of personal property that occurred when the association was a qualified savings association and did not exceed the limit.

(v) *Prompt corrective action not affected.* (A) A savings association shall compute its capital without regard to this paragraph (a)(3) of this section for purposes of prompt corrective action (12 U.S.C. 1831o), unless the savings association is adequately or well capitalized without applying the capital

treatment described in this paragraph (a)(3) and would be well capitalized after applying that capital treatment.

(B) A savings association shall compute its capital without regard to this paragraph (a)(3) for the purposes of applying 12 U.S.C. 1831o(g), regardless of the association's capital level.

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Dated: August 21, 1995.

By the Office of Thrift Supervision.

John F. Downey,

Director, Supervision.

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