

level recourse transactions. The eight commenters on this issue stated that as long as the amount of required capital held against the low level recourse transactions was prudently assessed based upon expected losses, actual losses would seldom, if ever, exceed the capital requirement. Thus, the insurance funds would not likely experience losses.

The fifth issue sought comment on whether the proposed low level recourse capital treatment would reduce transaction costs or otherwise help to facilitate the sale or securitization of banking organizations' assets. The eight commenters that responded to this issue were all of the opinion that the low level capital treatment generally would help lower transaction costs and help facilitate securitization.

Final Rule

After consideration of the comments received and further deliberation on the issues involved, particularly the requirements of section 350 of the Riegle Act, the Board is adopting a final rule amending the risk-based capital guidelines with respect to the treatment of low level recourse transactions. Specifically, the final amendments implement section 350 by reducing the capital requirements for all recourse transactions in which a state member bank contractually limits its recourse exposure to less than the full, effective risk-based capital requirement for the assets transferred. Although section 350 explicitly extends only to depository institutions, the Board, consistent with its proposal, is also issuing a parallel final amendment to its risk-based capital guidelines for bank holding companies.²

The final rule applies to low level recourse transactions involving all types of assets, including small business loans, commercial loans, and residential mortgages. In this regard, the Board notes that previously under the risk-based capital guidelines residential mortgage loans transferred with recourse were excluded from risk-weighted assets if the institution did not retain significant risk of loss. As proposed, this treatment would no longer apply and the low level recourse capital treatment the Board is now issuing would extend to these types of mortgage loan transfers.

²In addition to amending the risk-based capital guidelines to reduce the capital requirement for low level recourse transactions (see paragraph g of section III.D.1. of the guidelines), the Board is also making some technical, nonsubstantive changes to that section of the guidelines by identifying each paragraph in the section with a letter designation.

Under the low level recourse rule, a banking organization that contractually limits its maximum recourse obligation to less than the full effective risk-based capital requirement for the transferred assets would be required to hold risk-based capital equal to the contractual maximum amount of its recourse obligation. This requirement limits to one dollar the capital charge for each dollar of low-level recourse exposure. Under this dollar-for-dollar capital requirement, the capital charge for a 100 percent risk-weighted asset transferred with 3 percent recourse would be 3 percent of the value of the transferred assets, rather than the 8 percent previously required. Thus, a banking organization's capital requirement on a low level recourse transaction would not exceed the contractual maximum amount it could lose under the recourse obligation.

Under the final rule, an institution may reduce the dollar-for-dollar capital charge held against the recourse exposure on assets transferred with low level recourse for a transaction recognized as a sale under GAAP and for regulatory reporting purposes by the balance of any associated non-capital GAAP recourse liability account. In adopting this aspect of the final rule, the Board concurs with commenters that indicated that nonrecognition of the liability account would result in double coverage of the portion of the credit risk provided for in that account.

In applying the final rule, the Board will, as proposed, limit the capital requirement for an exposure to low level recourse retained in a transaction associated with a swap of mortgage loans for mortgage-related securities to the lower of the capital charge for the swapped mortgages or the combined capital charge for the low level recourse exposure and the mortgage-related securities, adjusted for any double counting.

In setting forth this final rule, the Board has considered the arguments that several commenters made for adopting for regulatory capital purposes the GAAP treatment for all assets sold with recourse, including those sold with low levels of recourse. Under such a treatment, assets sold with recourse in accordance with GAAP would have no capital requirement, but the GAAP recourse liability account would provide some level of protection against losses.

The Board continues to believe it would not be appropriate to adopt for regulatory capital purposes the GAAP treatment of recourse transactions, even if the transferring bank retains only a low level of recourse. In the Board's

view, the GAAP recourse liability account would be an inadequate substitute for maintaining capital at a level commensurate with the risks. One of the principal purposes of regulatory capital is to provide a cushion against unexpected losses. In contrast, the GAAP recourse liability account is, in effect, a specific reserve that is intended to cover only an institution's probable expected losses under the recourse provision. In this regard, the Board notes that the capital guidelines explicitly state that specific reserves may not be included in regulatory capital.

In addition, the amount of credit risk that is typically retained in a recourse transaction greatly exceeds the normal expected losses associated with the transferred assets. Thus, even though a transferring institution may reduce its exposure to potential catastrophic losses by limiting the amount of recourse it provides, it may still retain, in many cases, the bulk of the risk inherent in the assets. For example, an institution transferring high quality assets with a reasonably estimated expected loss rate of one percent that retains ten percent recourse in the normal course of business will sustain the same amount of losses it would have had the assets not been transferred. This occurs because the amount of exposure under the recourse provision is very high relative to the amount of expected losses. The Board believes that in such transactions the transferor has not significantly reduced its risk for purposes of assessing regulatory capital and should continue to be assessed regulatory capital as though the assets had not been transferred.

The GAAP reliance on reasonable estimates of all probable credit losses over the life of the receivables transferred poses additional concerns to the Board. While it may be possible to make such estimates for pools of consumer loans or residential mortgages, the Board is of the view that it is currently difficult to do so for other types of loans. Even if it is possible to make a reasonable estimate of probable credit losses at the time an asset or asset pool is transferred, the ability of an institution to make a reasonable estimate may change over the life of the transferred assets.

Finally, the Board is concerned that an institution transferring assets with recourse might estimate that it would not have any losses under the recourse provision, in which case it would not establish any GAAP recourse liability account for the exposure. If the transferor recorded either no liability or only a nominal liability in the GAAP