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Office of Thrift Supervision
Department of the Treasury

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MEMORANDUM FOR: **CHIEF EXECUTIVE OFFICERS**

FROM: Timothy Ward, Deputy Director
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SUBJECT: Risk Weighting Downgraded Securities

In November 2001, the Office of Thrift Supervision, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve, and the Federal Deposit Insurance Corporation issued a joint rule addressing regulatory capital standards including two methods for risk weighting certain mortgage and asset backed securities, the default approach and an optional ratings based approach (RBA)[1].

Many institutions have utilized the optional RBA to risk weight senior and mezzanine positions in securitizations rated by one of the nationally recognized statistical rating organizations (NRSRO). However, with the recent stresses on the financial markets, there have been numerous and sometimes dramatic changes in the ratings for many of these positions. Thus, the default treatment for risk weighting certain mortgage and asset backed securities has taken on increasing importance. In light of the large number of recent rating downgrades, the attachment to this memorandum offers further explanation and examples of how to risk weight downgraded securities.

The other federal banking regulators recently released Call Report Instructions similarly explaining how their regulated institutions should report the capital treatment for downgraded securities. These clarifying instructions were operational for first quarter 2009. In addition to this CEO Memorandum, OTS is issuing Thrift Financial Report (TFR) Questions and Answers for reporting downgraded securities and will publish clarifying TFR instructions for the June 2009 reporting cycle.

Please contact Teresa Scott, at 202-906-6478 or David Riley at 202-906-6669 if you have questions.

Attachment

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[1] See 12 CFR 567.6(b)(3).

ATTACHMENT TO CEO MEMO 307
RISK WEIGHTING DOWNGRADED SECURITIES

The capital rules allow institutions the option to risk weight mortgage and asset backed securities under the optional ratings based approach (RBA). To be eligible for the RBA, the asset or exposure must be rated by a NRSRO no lower than one category below investment grade with risk weights assigned as follows:

Long Term Rating Category	Example[1]	Risk weight
Highest or second highest investment grade	AAA or AA	20%
Third highest investment grade	A	50%
Lowest investment grade	BBB	100%
One category below investment grade	BB	200%
Two categories or more below investment grade	B	NOT ELIGIBLE

The RBA also has the following requirements:

— Traded positions must be rated by at least one NRSRO; if two or more NRSROs rate the position, the bank must use the lowest rating to determine the appropriate risk-weight category.

— Non-traded positions must be rated by more than one NRSRO and those NRSROs must base their ratings on the same criteria that they use to rate securities that are traded positions.

— The ratings must be publically available.

By way of illustration and given a $100 asset-backed security, the capital requirement would be as follows:

Long Term Rating Category	Example	Risk Weight	Required Capital
Highest or second highest investment grade	AAA or AA	20%	$100.00 * 20% * 8% = $1.60
Third highest investment grade	A	50%	$100.00 * 50% * 8% = $4.00
Lowest investment grade	BBB	100%	$100.00 * 100% * 8% = $8.00
One category below investment grade	BB	200%	$100.00 * 200% * 8% = $16.00

Under the RBA, when ratings on securities are changed, institutions must recalculate their risk based capital according to the new rating. For example, when a $100 security that is originally rated AAA and requiring $1.60 in capital is downgraded to BBB, the institution must recalculate the capital for that security and hold $8.00 of risk based capital. However, if a security is

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[1] These examples include the negative designations for all of the rating levels, e.g., BB-.

downgraded lower than the RBA chart permits (i.e., lower than one category below investment grade), that security becomes ineligible for the RBA. In such cases, institutions must risk weight the security pursuant to 12 CFR 567.6(b) (1) and (2).[2]

<u>Risk Weighting Senior Positions</u>
Under 12 CFR 567.6(b)(1) and (2), these downgraded or unrated securities are risk weighted based on the position of the security in the securitization structure. If the security is in the most senior position in terms of credit risk, institutions generally must use the risk weight appropriate for the underlying assets. Institutions should multiply the dollar amount of the security times the risk weight appropriate to the underlying obligor or collateral. For example:

<u>Examples (based on a $100 security):</u>

— <u>Situation 1</u>: where underlying assets are 100% risk-weighted (e.g., credit cards or non qualifying mortgage loans): $100*100%*8% = $8 required capital

— <u>Situation 2</u>: where underlying assets are 50% risk-weighted (qualifying mortgage loans[3]): $100*50%*8% = $4 required capital

If there is a portion of a senior security composed of underlying loans that are delinquent, that portion should not be assigned a risk-weight lower than 100%.

— <u>Situation 3</u>: for mortgage backed securities where the underlying assets represent both qualifying and nonqualifying mortgage loans, the institution must risk weight the nonqualifying portion at 100%. Assume $100 security supported by 40% nonqualifying loans and 60% qualifying loans. The required capital would be calculated as $100*40%*100%*8% *plus* $100*60%*50%*8% = $5.60.[4]

<u>Risk Weighting Mezzanine Positions</u>
If the security is in the "mezzanine" position, institutions must use the "gross-up" approach that is required by 12 CFR 567.6(b)(1). The gross-up approach applies to recourse obligations and direct credit substitutes as both are defined in 12 CFR 567.1. For regulatory capital purposes, a security is considered "mezzanine" if it is not, functionally for credit risk purposes, the most senior in the structure—regardless of how it may be named, and if it is also not an equity tranche/residual interest that absorbs losses before any other tranche in a structure. In the gross-up approach, an institution must calculate the capital required for both the security *and* the <u>pro rata</u> portion of all more senior securities, that is, those securities in the structure deriving credit support from the particular mezzanine security subject to risk-weighting.

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[2] Unrated securities are also risk weighted under 12 C.F.R. 567.6 (b) (1) and (2). In those circumstances where the accounting rules require an institution to write-down an asset, there is generally a dollar-for-dollar regulatory capital impact based on the amount of loss. The risk weight on the remainder of the written-down asset would be calculated using the same approaches discussed below.

[3] See 12 CFR 567.1 for the definition of a Qualifying Mortgage Loan. In order to use the 50% risk weight instead of 100% risk weight, there must be sufficient documentation to demonstrate that the underlying loans meet the definition of qualifying mortgage loans.

[4] Again, the institution must be able to defend this treatment with information about the underlying collateral and its performance.

An institution holding the entire mezzanine position must multiply the amount of the direct credit substitute (in this case the mezzanine security) *plus the full amount of the assets it supports (all the more senior positions in the structure)* by the risk weight appropriate for the underlying obligor or collateral (100% for most assets).[5] The reason for the relatively high capital treatment under the gross-up approach is that the mezzanine securities hold the concentrated credit risk for all the securities more senior to them (i.e., the mezzanine securities absorb losses before the senior securities).

The following example illustrates the calculation of the capital requirement for a mezzanine security in a simple structure for an available-for-sale or held-to-maturity security:

Example 1: Simple Example of the Gross-up Approach

Senior Security owned by others $75 par value	**Assume:** A = M + S C = A * 8% **Where:** A = Assets to risk weight M = Face amount[6] of mezzanine security owned by savings association S = Par value of all more senior securities C = Capital requirement
Mezzanine Security owned by the savings association $20 face amt.	**Capital Requirement =** A = $20 + $75 A = $95 C = $95*.08 = $7.60
Residual Interest owned by others	**$95 * 100% risk weight * 8% = $7.60 required capital**

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[5] As with senior positions, when determining the appropriate risk weight to apply to the "grossed up" asset, for mortgage backed securities where the underlying assets represent both qualifying and nonqualifying mortgage loans, the institution must risk weight the nonqualifying portion at 100%.

[6] For risk-based capital purposes, the "face amount" of an available for sale security and a held-to-maturity security is its amortized cost.

When a mezzanine position has been divided into various securities with equal standing in terms of credit risk, each owned by different parties including the savings association, the gross-up amount would include only the savings association's *proportional* share of the senior securities (i.e., the area specified in the diagrams below).

Example 2: Pro Rata Gross-up Example

PRO RATA GROSS UP AMOUNT

SENIOR SECURITIES
owned by others

TOTAL $75 par value

Mezzanine position owned by savings association

Par value = $10
Face amount = $9.50

Mezzanine position owned by others
Par value = $10

Residual position owned by others

Use the following formula to calculate assets to risk weight for Available-for-Sale or Held-to-Maturity Securities

Assume:

$A = M + (S \times P)$
$C = A * 8\%$

Where:

A = Assets to risk weight under the gross-up approach
M = Face amount of the savings association's mezzanine security ($9.50 in the example)
S = Par value of all more senior securities ($75 in the example)
P = Proportion of the par value of the savings association's mezzanine security relative to all other equally positioned mezzanine securities (This is 0.50 in the example because the $10 par value of savings association's mezzanine security is 50% of $20 total par value of all equally positioned mezzanine securities)

Capital Requirement =

$A = \$9.50 + (\$75 \times 0.50)$
$A = \$47$
$C = \$47 * .08 = \$3.76$

The following example includes a similar structure; however, in this case the savings association's security is in its trading portfolio. For a trading security, the face amount is the *fair value* of the security.

Example 3: Pro Rata Gross-up for a Trading Security

PRO RATA
GROSS UP
AMOUNT

SENIOR SECURITIES owned by others TOTAL $75 par value	
Mezzanine position owned by savings association Par value = $10 Fair Value = $4.00	Mezzanine position owned by others Par value = $10
Residual position owned by others	

Use the following formula to calculate assets to risk weight for Trading Securities:

Assume:

A = M + (S x P)
C = A * 8%

Where:

A = Assets to risk weight under the gross-up approach
M = Face amount (*fair value*) of the savings association's mezzanine security ($4.00 in the example)
S = Par value of all more senior securities ($75 in the example)
P = Proportion of the par value of the savings association's mezzanine security relative to all other equally positioned mezzanine securities (This is 0.50 in the example because the $10 par value of savings association's mezzanine security is 50% of $20 total par value of all equally positioned mezzanine securities)

Capital Requirement =

A = $4.00 + ($75 x 0.50)
A = $41.50

C = $41.50*.08 = $3.32

Risk Weighting Low Level Exposures

Under 12 CFR 567.6(b)(7)(i), the OTS low level exposure rule, and consistent with the other federal banking agency rules, if the maximum contractual exposure to loss is less than the effective risk-based capital requirement for the assets supported by the savings association's position, the risk-based capital requirement is limited to that contractual exposure.

Example 4: Pro Rata Gross-up where the Low Level Exposure rule governs (using an available-for-sale or held-to-maturity security)

PRO RATA GROSS UP AMOUNT

SENIOR SECURITIES owned by others

TOTAL $80 par value

Mezzanine position owned by savings association

Par value = $3
Face amount = $2.75

Mezzanine position owned by others
Par value = $2

Residual position owned by others

Use the following formula to determine the applicability of low level exposure rule:

Assume:

$A = M + (S \times P)$
$C = A * 8\%$

Where:

C = Capital charge
A = Assets to risk weight under the gross-up approach
M = Face amount of the savings association's mezzanine security ($2.75 in the example)
S = Par value of all more senior securities ($80 in the example)
P = Proportion of the par value of the savings association's mezzanine security relative to all other equally positioned mezzanine securities (This is 0.60 in the example because the $3 par value of savings association's mezzanine security is 60% of $5 total par value of all equally positioned mezzanine securities)

Capital Requirement =

$A = \$2.75 + (\$80 \times 0.60)$
$A = \$50.75$

$C = \$50.75 * .08 = \$4.06$

$4.06 is greater than the face amount of the institution's exposure of $2.75. Therefore, the low level exposure rule applies and the risk based capital charge is capped at $2.75.

Risk Weighting Residual Positions

For residual interests, the capital requirement is equal to the face amount of the asset, otherwise known as "dollar-for-dollar" capital requirement (roughly the equivalent of a 1250% risk weight). Residual interests are furthered addressed in Appendix A of Section 120 of the Examination Handbook and in the TFR Instructions.

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