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DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Part 3

[Docket No. 97-17]

RIN 1557-AB14

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 325

RIN 3064-AB57

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

12 CFR Part 567

[Docket No. ██████████]

RIN 1550-AB11

Risk-Based Capital Requirements:

Transfers of Small Business Loan Obligations with Recourse

AGENCIES: Office of the Comptroller of the Currency (OCC), Treasury; Federal Deposit Insurance Corporation (FDIC); and Office of Thrift Supervision (OTS), Treasury.

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ACTION: Joint final rule.

SUMMARY: The OCC, FDIC, and OTS (agencies) are issuing final rules on the risk-based capital treatment of transfers of small business loans or leases of personal property with recourse, as required by section 208 of the Riegle Community Development and Regulatory Improvement Act of 1994. The rules address the risk-based capital treatment of transfers of small business loans or leases of personal property with recourse, and, consistent with the statutory purpose, are designed to facilitate such transfers.

DATES: The final rule is effective January 1, 1998.

OCC: David Thede, Senior Attorney, Securities and Corporate Practices Division (202/874-5210); or Tom Rollo, National Bank Examiner, Office of the Chief National Bank Examiner (202/874-5070), Office of the Comptroller of the Currency, 250 E Street, SW., Washington, DC 20219.

FDIC: For supervisory issues, Stephen G. Pfeifer, Examination Specialist, (202/898-8904), Accounting Section, Division of Supervision; for legal issues, Marc J. Goldstrom, Counsel, (202/898-8807), Legal Division, Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, D.C. 20429.

OTS: John F. Connolly, Senior Program Manager for Capital Policy (202/906-6465), Supervision; or Valerie J. Lithotomos, Counsel, Banking and Finance (202/906-6439), Regulations and Legislation Division, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street. NW., Washington, DC 20552.

SUPPLEMENTARY INFORMATION:

Background

The agencies are issuing final rules on the risk-based capital treatment of transfers of small business obligations with recourse as required by section 208 of the Riegle Community Development and Regulatory Improvement Act of 1994 (CDRI Act), 12 U.S.C. 1835. The agencies had previously published interim rules implementing section 208 and at that time requested comment on the changes. 60 FR 47455 (OCC); 60 FR 45606 (FDIC); 60 FR 45618 (OTS). The OTS and OCC are now issuing final rules that are unchanged from their respective interim rules. The FDIC is issuing a final rule that is substantially the same as its interim rule.

Banks and thrifts typically transfer assets with recourse as part of securitization transactions. Sections 201 through 210 of the CDRI Act were intended to increase small business access to capital by removing impediments in existing law to the securitization of small business loans and leases.

Under the agencies' current risk-based capital standards, assets transferred with recourse are included in risk-weighted assets.¹ Section 208 prescribes modified risk-based capital requirements for transfers of small business loans or leases of personal property with recourse that are sales under generally accepted accounting principles (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 institution sold a \$1,000 pool of small business loans with recourse, but limited its recourse liability to the first \$100 of loss on the pool, section 208 would limit the applicable capital charge to \$8 (8 percent of the \$100 of retained recourse).²

By contrast, the agencies' risk-based capital regulations generally require institutions to include in risk-weighted assets the full value of assets transferred with recourse multiplied by the appropriate risk-weight percentage. If that rule were applied to the foregoing example, the

¹If an institution's maximum contractual liability under a recourse obligation is less than the capital requirement for the credit risk exposure on the underlying assets, then, under the low-level recourse rule, the capital requirement for the recourse exposure is equal to the institution's maximum contractual liability.

²For purposes of determining the amount of risk-weighted assets for assets transferred with recourse that receive the preferential capital treatment under section 208, the recourse liability account established in accordance with GAAP would not be subtracted from the amount of the recourse obligation.

institution'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 capital charge under section 208.³

Section 208 limits the availability of the favorable treatment as follows:

(1) To apply section 208 to a transaction, an institution must be a "qualified insured depository institution" at the time of the sale with recourse. A qualified insured depository institution is one that is either well capitalized or, with the approval of its primary regulator, adequately capitalized (in either case, without regard to section 208). If an institution loses its "qualified" status, transactions completed while the institution was qualified will continue to receive the favorable capital treatment.

(2) The total outstanding amount of recourse retained by an institution with respect to transfers of small business loans and leases of personal property to which section 208 has been applied may not exceed 15 percent of the total risk-based capital of the institution, unless the institution's primary federal regulatory agency, by regulation or order, specifies a greater amount.

Comments

³Under the low-level recourse rule, if the institution had limited the recourse obligation to \$60 on the loan pool, its capital charge would be \$60.

In response to the interim rule, the agencies received comments from one bank, three banking trade associations, one accountants' professional association, and one other trade association. All of the commenters supported the interim rule.

Section 208 requires the agencies to use the definition of "small business" established by the Small Business Administration (SBA) in 13 CFR part 121 pursuant to 15 U.S.C. 632 in determining which loans and leases are eligible for the special capital treatment. Two commenters observed that this definition is difficult to apply with certainty in the absence of voluminous information gathered from each loan applicant, and that collecting this information would be prohibitively expensive for the lender and the loan applicant. The commenters noted that, in extending small business leases, some institutions use computerized credit scoring that relies on sales and employment information available from published reports. This information does not exactly match the criteria in the SBA's definition. Because the transactions are typically very small, these commenters stated, the cost of obtaining the additional information required by the SBA's definition for each lease would effectively preclude use of section 208 to facilitate securitization of these leases.

The agencies have considered these comments and believe that section 208 and the agencies' regulations permit an institution to apply the section 208 capital treatment without incurring this additional cost. If the specific information required by the SBA definition is not readily available, an institution should use its best efforts to ensure that, based on other information that is available to the institution, the borrower would meet the SBA criteria for a

small business. Additionally, an institution should not classify a borrower as a small business if the institution has access to readily available information that is not consistent with such a classification. If, during the course of an examination, it is determined that the information being used to evaluate whether a borrower is a small business is being used in a manner that is inconsistent with or that appears to circumvent the provisions of the actual SBA definition of a small business, the agencies may require appropriate adjustments to be made to the institution's regulatory capital calculations for those periods during which the SBA definition was not consistently applied.

Another commenter observed that the agencies did not state in the interim rules that the accounting principles for transfers of small business loans and leases with recourse in Consolidated Reports of Condition and Income (Call Reports) and Thrift Financial Reports should be governed by GAAP. All of the agencies intend to apply GAAP as required by section 208. No regulatory amendments will be necessary to implement this change. As of January 1997, all institutions generally must follow GAAP for financial reporting in their Call Reports and Thrift Financial Reports, including the reporting of transfers of small business loans with recourse in accordance with section 208.⁴

⁴Because the Call Report instructions have been revised to conform with GAAP in the reporting treatment of all transfers of financial assets, including small business loans and leases transferred with recourse, the FDIC has decided that the interim rule amendment that added a new paragraph (e) to § 325.3 of the FDIC's leverage capital rule is now redundant. Therefore, the FDIC's final rule removes this paragraph.

This commenter also noted that the interim rule requires an institution to hold capital against the entire face amount of recourse retained and also to establish a liability reserve for expected future losses associated with the recourse arrangements. The commenter stated that this requirement would result in an excessive capital requirement and that the retained recourse liability should be reduced by the amount of the reserve before calculating capital requirements.

The agencies have decided not to change the treatment in the interim rule. Section 208 specifically requires the treatment described in the interim rule. Also, as the FRB noted in its final rule implementing section 208, capital and the GAAP reserve serve different purposes. The GAAP reserve covers expected losses, while capital is maintained to absorb unexpected losses. 60 FR 45613 (August 31, 1995).

Three commenters suggested that the agencies make the risk-based capital treatment described in section 208 available for all sales of assets with recourse. One commenter noted that section 208(h) permits the agencies to adopt an alternative capital treatment that does not require more aggregate capital and reserves than the treatment described in section 208. This commenter urged the agencies to use this discretion to further reduce the capital requirement on transfers of small business obligations with recourse. The agencies are not undertaking that change now, but are continuing to review the risk-based capital requirements applicable to sales of assets with recourse. The agencies will consider the commenters' suggestions in the context of that review.

One commenter asked the agencies to confirm that an institution may apply the section 208 treatment to small business loans transferred with recourse after March 22, 1995, the statutory implementation date, even though the agencies' interim rules were published in August and September of 1995. Consistent with the guidance previously provided in the agencies' interim rules, the agencies will not object if an institution chooses to apply the provisions of the final rule to small business obligations that were transferred with recourse between March 22, 1995 and the effective date of the final rule, provided the institution would have been a qualifying institution under the provisions of the rule at the time of the transfer.

Under the statute, an adequately capitalized institution will be a "qualified institution" eligible to use the capital treatment for small business loans with the written permission of the responsible agency. One commenter to the OTS suggested that all adequately capitalized institutions should be permitted to use the section 208 capital treatment unless the agency determines that an individual minimum capital requirement or other action is necessary for safety and soundness purposes. The OTS generally intends to allow institutions to use the section 208 computational method if OTS determines institutions will have capital commensurate with their risk exposure.

One commenter thought that the OCC's treatment of low-level recourse transactions differed from that of the FDIC and FRB. Although this issue is not directly related to the final rule implementing section 208, the OCC wishes to clarify that its treatment of low-level recourse transactions is consistent with that of the FDIC and FRB. A low-level recourse transaction is a

transaction in which the amount of retained recourse is less than the effective capital requirement on the underlying assets. As required by section 350 of the CDRI Act, 12 USC 4808, the OCC, FDIC, and FRB have adopted rules limiting the risk-based capital requirement for low-level recourse obligations to the bank's maximum contractual obligation under the recourse provision. (The OTS already had such a rule in place.⁵) In addition, the OCC, FRB, and FDIC, acting under the auspices of the Federal Financial Institutions Examination Council, have jointly issued Call Report instructions describing the regulatory reporting treatment applicable to low-level recourse transactions in the regulatory capital schedule. (See Call Report Instructions for Schedule RC-R -- Regulatory Capital.)

The preamble to the OTS's interim rule on section 208 also addressed the implementation of section 350 and requested comments on the proper calculation of the risk-based capital ratio for low-level recourse exposures. The OTS received one comment on low-level recourse exposures, which supported the current OTS approach. However, because this issue was not raised in the FDIC and OCC interim rules implementing section 208, the OTS is not addressing the issue in this joint final rule. The OTS will consider this comment in reviewing its policy guidance and Thrift Financial Report instructions.

Prompt Corrective Action

⁵12 CFR 567.6(a)(2)(i)(C).

Section 208(f) states that 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 38 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 operation of the prompt corrective action system. See S. Rep. No. 103-169, 103d Cong., 1st Sess. 38, 69 (1994). 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 institutions that are less than adequately capitalized. Therefore, allowing an institution that is adequately capitalized without the section 208 treatment⁶ to use section 208 for purposes of determining whether the institution is well capitalized generally would not affect the application of the prompt corrective action sanctions to the institution. Other statutes and regulations treat an institution 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

⁶It is very unlikely but theoretically possible that an institution that is undercapitalized without section 208 would become well capitalized if it applied the treatment in section 208. Because section 208 was not intended to affect prompt corrective action, and because allowing an undercapitalized institution to become well capitalized would affect prompt corrective action, the agencies interpret section 208 not to allow an undercapitalized institution to use the capital treatment it describes to become well capitalized for purposes of prompt corrective action.

of sanctions. Permitting an institution to 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 institution as well capitalized rather than adequately capitalized. If an agency determines that an institution is in an unsafe or unsound condition or is engaging in an unsafe or unsound practice, section 38(g) (12 U.S.C. 1831o(g)) authorizes the agency (1) to reclassify a well capitalized institution as adequately capitalized and (2) to require an adequately capitalized institution (but not a well capitalized institution) to comply with certain prompt corrective action provisions as if the institution were undercapitalized. Because the text and legislative history of section 208 indicate that it was not intended to affect prompt corrective action, the agencies believe that section 208 does not affect the capital calculation for purposes of section 38(g) regardless of the institution's capital level.

Thus, an institution may use the capital treatment described in section 208 when determining whether it is well capitalized for purposes of prompt corrective action as well as for other regulations that reference the well capitalized capital category.⁷ An institution 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

⁷An institution that is subject to a written agreement or capital directive as discussed in the agencies' prompt corrective action regulations would not be considered well capitalized.

prompt corrective action capital categories.⁸ The agencies will disregard the capital treatment described in section 208 for purposes of section 38(g).

Final Rules

The OCC is adopting its interim rule without change.

The OTS is also adopting its interim rule without change.

The FDIC is adopting its interim rule with one technical, non-substantive change:

§ 325.5(e) is being removed as redundant.

Regulatory Flexibility Act

Each of the agencies certifies that this final rule will not have a significant economic impact on a substantial number of small entities. This rulemaking is required by statute. The final rule authorizes an alternative method of calculating risk-based capital that permits institutions to hold less capital for certain recourse obligations. The final rule will benefit qualified institutions regardless of size. The final rule will not affect any institution's risk-based capital for prompt corrective action purposes.

⁸Under section 208, the capital calculation used to determine whether an institution is well capitalized differs from the calculation used to determine whether an institution 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.

Executive Order 12866

The OCC and OTS have determined that this final rule is not a significant regulatory action under Executive Order 12866. Under the final rule, some institutions' risk-based capital ratios may improve. This change will not have a material effect on the safety and soundness of affected institutions and will not affect their measured risk-based capital for prompt corrective action purposes.

Paperwork Reduction Act

The Agencies have determined that this proposal would not increase the regulatory paperwork of banking organizations pursuant to the provisions of the Paperwork Reduction Act (44 U.S.C. 3501 et seq.).

Unfunded Mandates Act of 1995

Section 202 of the Unfunded Mandates Act of 1995 (Unfunded Mandates Act) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in the expenditure by state, local, and tribal governments, in the aggregate, or by the private sector, of \$100 million or more in any one year. If a budgetary impact statement is required, section 205 of the Unfunded Mandates 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 final rule authorizes an alternative method of calculating capital that permits institutions to elect to hold less capital for certain recourse obligations.

Because the agencies have determined that the final rule will not result in expenditures by state, local, and tribal governments, or by the private sector, of more than \$100 million in any one year, the agencies have not prepared a budgetary impact statement or specifically addressed the regulatory alternatives considered.

List of Subjects

12 CFR Part 3

Administrative practice and procedure, Capital risk, National banks, Reporting and recordkeeping requirements.

12 CFR Part 325

Bank deposit insurance, Banks, Banking, Capital adequacy, Reporting and recordkeeping requirements, Savings associations, State nonmember banks.

12 CFR Part 567

Capital, Reporting and recordkeeping requirements, Savings associations.

Office of the Comptroller of the Currency

12 CFR Chapter I

Issuance

For the reasons set out in the preamble, the interim rule amending 12 CFR part 3 which was published at 60 FR 47455 on September 13, 1995, (as corrected by the notice published in the Federal Register at 60 FR 64115 on December 14, 1995) is adopted as a final rule without change.

Office of Thrift Supervision

12 CFR Chapter V

Issuance

Accordingly, the Office of Thrift Supervision hereby amends title 12, Chapter V of the Code of Federal Regulations by adopting as final the interim rule published at 60 FR 45618 (August 31, 1995) without change.

Federal Deposit Insurance Corporation

12 CFR Chapter III

Issuance

For the reasons set out in the preamble, the Board of Directors of the Federal Deposit Insurance Corporation amends part 325 of title 12 of the Code of Federal Regulations as follows:

1. The authority citation for Part 325 continues to read as follows:

Authority: 12 U.S.C. 1815(a), 1815(b), 1816, 1818(a), 1818(b), 1818(c), 1818(t),
1819(Tenth), 1828(c), 1828(d), 1828(i), 1828(n), 1828(o), 1831o, 1835, 3907, 3909, 4808; Pub.
L. 102-233, 105 Stat. 1761, 1789, 1790 (12 U.S.C. 1831n note); Pub. L. 102-242, 105 Stat. 2236,
2355, 2386 (12 U.S.C. 1828 note).

2. In § 325.3 paragraph (e) is removed.

* * * * *

3. In appendix A to part 325, paragraph 6 to section II.B. will continue to read as follows:

APPENDIX A TO PART 325 -- Statement of Policy on Risk-Based Capital

* * * * *

II. * * *

B. * * *

6. Small Business Loans and Leases on Personal Property Transferred with Recourse –

(a) Notwithstanding other provisions of this appendix A, a qualifying institution that has transferred small business loans and leases on personal property (small business obligations) with recourse shall include in risk-weighted assets only the amount of retained recourse, provided two conditions are met. First, the transaction must be treated as a sale under generally accepted accounting principles (GAAP) and, second, the qualifying institution must establish pursuant to GAAP a non-capital reserve sufficient to meet the institution's reasonably estimated liability under the recourse arrangement. Only loans and leases to businesses that meet the criteria for a small business concern established by the Small Business Administration under section 3(a) of the Small Business Act (15 U.S.C. 632(a)) are eligible for this capital treatment.

(b) For purposes of this appendix A, a qualifying institution is a bank that is well capitalized. In addition, by order of the FDIC, a bank that is adequately capitalized may be deemed a qualifying institution. In determining whether a bank meets the qualifying institution criteria, the prompt corrective action well capitalized and adequately capitalized definitions set forth in § 325.103 shall be used, except that the bank's capital ratios must be calculated without regard to the preferential capital treatment for transfers of small business obligations with recourse specified in section II.B.6.(a) of this appendix A. The total outstanding amount of recourse retained by a qualifying institution on transfers of small business obligations receiving the preferential capital treatment cannot exceed 15 percent of the institution's total risk-based capital. By order, the FDIC may approve a higher limit.

(c) If a bank ceases to be a qualifying institution or exceeds the 15 percent of capital limit under section II.B.6.(b) of this appendix A, the preferential capital treatment will continue to apply to any transfers of small business obligations with recourse that were consummated during the time the bank was a qualifying institution and did not exceed such limit.

(d) The risk-based capital ratios of a bank shall be calculated without regard to the preferential capital treatment for transfers of small business obligations with recourse specified in paragraph (a) of this section for purposes of:

(i) Determining whether a bank is adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized under the prompt corrective action capital category definitions specified in § 325.103; and

(ii) Applying the prompt corrective action reclassification provisions specified in § 325.103(d), regardless of the bank's capital level.

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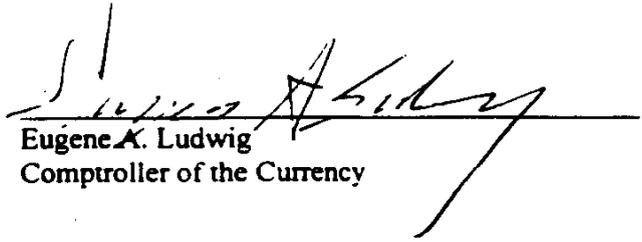
July 10-15-97

~~[This signature page pertains to the final rules on the risk-based capital treatment of small business loans and leases sold with recourse.]~~

OFFICE OF THE COMPTROLLER OF THE CURRENCY

September 12, 1997

Date



Eugene A. Ludwig
Comptroller of the Currency

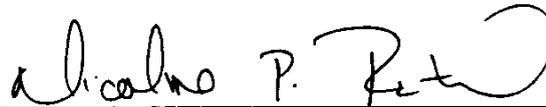
~~[This signature page pertains to the Federal Register notice publishing final rules relating to the risk-based capital treatment of small business loans and leases sold with recourse.]~~

OFFICE OF THRIFT SUPERVISION

By the Office of Thrift Supervision

September 18, 1997

Date

A handwritten signature in black ink, appearing to read "Nicolas P. Retsinas", written over a horizontal line.

Nicolas P. Retsinas

Director

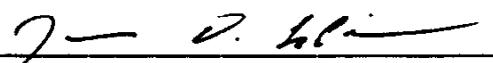
May 10-14-97

~~[This signature page pertains to the Federal Register notice publishing final rules relating to the risk-based capital treatment of small business loans and leases sold with recourse.]~~

FEDERAL DEPOSIT INSURANCE CORPORATION

By the order of the Board of Directors.

Dated at Washington, D.C. this 16th day of September, 1997.



James B. LaPierre
Deputy Executive Secretary
(Seal)

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