Office of Thrift Supervision
Department of the Treasury

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MEMORANDUM FOR: **CHIEF EXECUTIVE OFFICERS**

FROM: Timothy Ward, Deputy Director Timothy T Ward
Examinations, Supervision, and Consumer Protection

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

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

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
Mezzanine Security owned by the savings association $20 face amt.
Residual Interest owned by others

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

Capital Requirement =

A = $20 + $75
A = $95
C = $95*.08 = $7.60

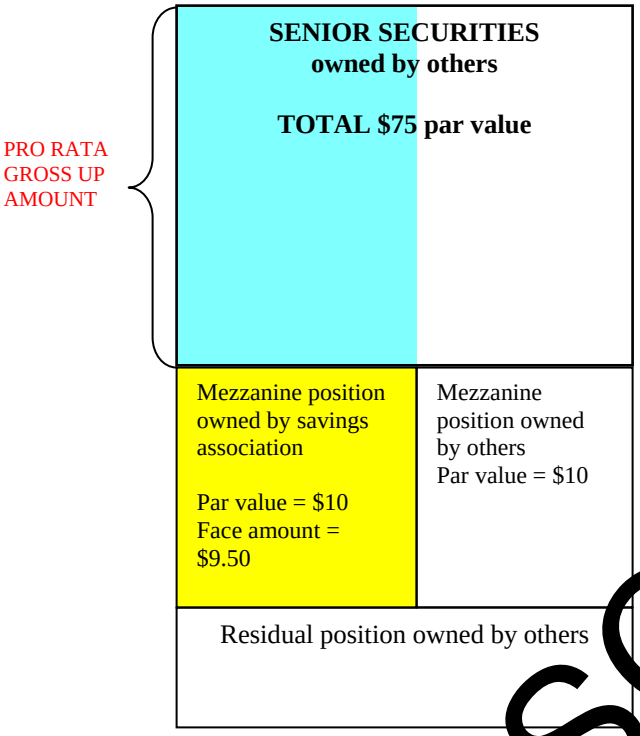
$95 * 100% risk weight * 8% =
$7.60 required capital

[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



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

Assume:

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

Where:

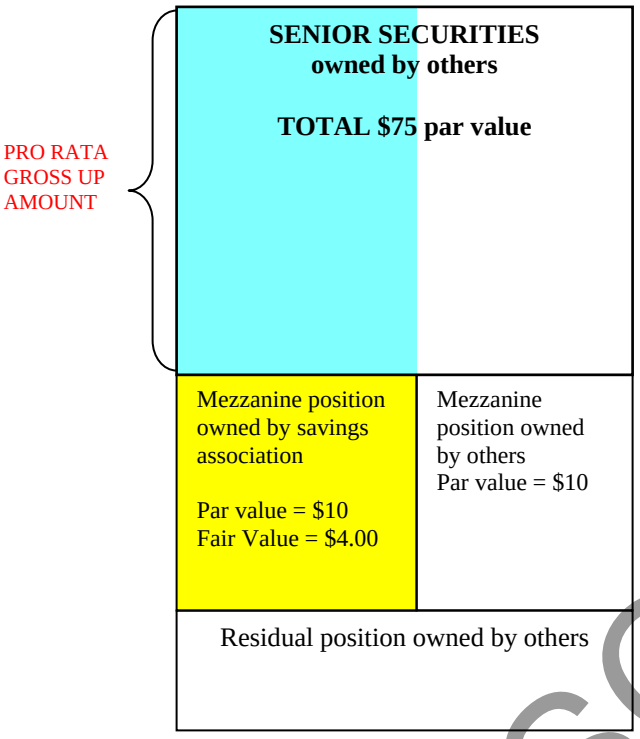
A = Assets to risk weight under the gross-up approach
M = Face amount of the savings association's mezzanine security ($9.50 in the example)
S = Par value of all more senior securities ($75 in the example)
P = Proportion of the par value of the savings association's mezzanine security relative to all 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 x 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



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 =

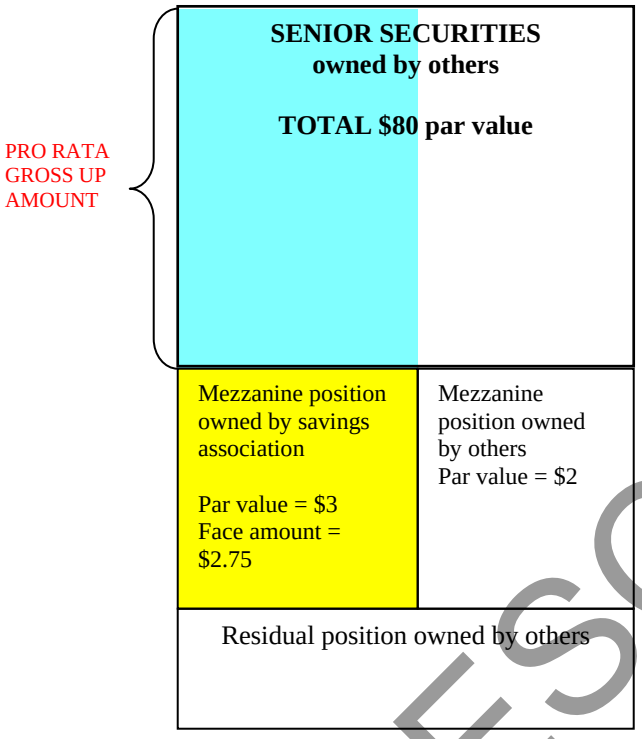
A = $4.00 + ($75 x 0.50)
A = $41.50

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)



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

Assume:

A = M + (S x 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 x 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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