
**Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision**

March 17, 2003

**Interpretive Letter #987
April 2004
12 CFR 3**

Dear [],

Thank you for your letters requesting clarification on the appropriate capital treatment for second liens in structured mortgage transactions. As you know, the Agencies issued a final rule on November 29, 2001 entitled the "Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations" (Final Rule). The Final Rule addresses a variety of exposures retained or assumed by a banking organization. In the preamble to the Final Rule, the Agencies stated that "second liens will not, in most instances, constitute recourse. Second mortgages or home equity loans generally will not be considered recourse arrangements unless they actually function as credit enhancements." [66 FR 59621]

In drafting the Final Rule, the Agencies' determined that second mortgages generally would not meet the definition of a recourse arrangement, even when the first and second mortgage were made to the same borrower at the same time. The Agencies view the second mortgage as a separate transaction that does not -- in and of itself -- serve as a credit enhancement. Generally, the holder of the first mortgage has a senior claim on the collateral supporting the mortgages but would not have any rights to payments made on the second mortgage. This is in contrast to a typical recourse arrangement where any payments made by the underlying borrowers are first used to satisfy the claims of the senior investors in accordance with the terms and conditions of the transaction. Further, the credit risk present in most structured second liens is similar in most aspects to second liens originated on a standalone basis, which are not considered to be recourse obligations under our existing rules. For these reasons, the Agencies do not believe that the second mortgage liens referenced in your letters meet the definition of recourse as set forth in the Final Rule.

The Agencies are aware of elevated credit risk related to high loan-to-value financing. Institutions with concentrations of second liens in structured mortgage programs are often subject to higher examiner scrutiny and, in some cases, higher capital requirements. For example, the Agencies have issued subprime and high loan-to-value residential real estate guidance that indicates when examiners should assess higher capital charges for loans that pose a higher degree of credit risk. We will also consider your concerns, particularly with regard to the high loan-to-value structured mortgage programs, in future revisions to our capital standards as part of our efforts to more closely align regulatory capital requirements with risk.

Please contact Tom Boemio, Senior Supervisory Financial Analyst at the Board on 202-452-2982, Amrit Sekhon, Risk Expert at the OCC on 202-874-5211, Jason Cave, Chief, Capital Markets Policy at the FDIC, or Michael Solomon, Senior Program Manager for Capital Policy at the OTS on 202-906-6669, if you have any further questions with regard to this clarification of the capital treatment of second liens in structured mortgages.

Sincerely,

/s/

Tommy Snow
Director, Capital Policy
Comptroller of the Currency

/s/

Norah Barger
Deputy Associate Director
Federal Reserve Board

/s/

John C. Price
Director, Supervision Policy
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/s/

George French
Deputy Director
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