

FEDERAL RESERVE BANK OF SAN FRANCISCO
101 MARKET STREET, SAN FRANCISCO, CALIFORNIA 94105

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**BANKING SUPERVISION AND REGULATION:
ASSET SECURITIZATIONS**

To State Member Banks, Bank
Holding Companies, U.S. Branches
and Agencies of Foreign Banks,
and Others Concerned,
in the Twelfth Federal Reserve District

**Covenants in Securitization Documents Linked to Supervisory Actions or Thresholds
(SR 02-14)**

Recent examination of documentation governing securitization transactions have uncovered covenants that use adverse supervisory actions or the breach of supervisory thresholds as triggers for early amortization events or the transfer of servicing. Examples of supervisory actions include a downgrade in the organization's CAMELS rating, an enforcement action, or a downgrade in a bank's prompt corrective action capital category. The inclusion in securitization documents of supervisory-linked covenants will be considered by the federal banking agencies as an "unsafe and unsound banking practice" that undermines the objective of supervisory actions and thresholds. An early amortization or transfer of servicing triggered by such events can create or exacerbate liquidity and earnings problems for a banking organization that may lead to further deterioration in its financial condition.

On May 23, 2002, the federal banking agencies issued guidance alerting banking organizations' management and boards of directors to the safety and soundness implications of certain covenants included in securitization documents. The guidance is posted online at the Board of Governors web site at <http://www.federalreserve.gov/boarddocs/SRLETTERS/2002/SR0214a1.pdf>.

Covenants that contain triggers tied, directly or indirectly, to supervisory actions or thresholds can result in the early amortization of a securitization at a time when the sponsoring organization's ability to access other funding sources is limited. The early amortization of a securitization's bonds can cause investors to lose confidence in the stability of the sponsoring organization's asset-backed securities, limiting its ability to raise new funds through securitization. At the same time the organization must fund new receivables on balance sheet, potentially resulting in liquidity problems. Moreover, the existence of a supervisory-linked trigger potentially could inhibit supervisors from taking action intended to address problems at a troubled institution because they could trigger an event that worsens an institution's condition or causes its failure.

The Federal Reserve and the other federal banking agencies are further concerned that covenants related to supervisory actions may obligate a banking organization's management to disclose confidential examination information, such as the CAMELS rating. Disclosure of such information by a banking organization's directors, officers, employees, attorneys, auditors, or independent auditors, without explicit authorization by the institution's primary regulator, violates the agencies' information disclosure rules and may result in follow-up supervisory actions.

A banking organization's management should ensure that documents governing securitizations it sponsors do not include any covenants related to supervisory actions or thresholds. Effective immediately, the use of covenants that allow early amortization of a securitization or compel the transfer of servicing as a result, directly or indirectly, of the occurrence of a supervisory action or event will, under appropriate circumstances, be criticized as an unsafe and unsound banking practice. Moreover, banking organization management is encouraged to amend, modify, or remove these covenants from existing transactions. Any impediments a banking organization may have to taking such actions should be documented and discussed immediately with its Federal Reserve Bank.

Implicit Recourse Provided to Asset Securitizations (SR 02-15)

Over the last several months, the Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Office of Thrift Supervision have become aware of a number of instances in which a banking organization provided credit support beyond its contractual obligation to one or more of its securitizations. This type of support is commonly referred to as "implicit recourse" (and sometimes as "moral recourse"). Implicit recourse is of supervisory concern because it demonstrates that the securitizing institution is re-assuming risk associated with the securitized assets that the institution initially transferred to the marketplace.

Supervisors should be alert for instances where a banking organization provides implicit recourse to a securitization. Providing implicit recourse can pose a high degree of risk to a banking organization's financial condition and to the integrity of its regulatory and public financial reports. Heightened attention must be paid to situations in which an institution is more likely to provide implicit recourse, for example, when securitizations are nearing performance triggers that would result in an early amortization event.¹ Supervisors should review securitization documents, such as pooling and servicing agreements, to ensure that the selling institution limits any support to the securitization to the terms and conditions specified in the securitization documents. Supervisors also should review a sample of loans or receivables transferred between the seller and the trust to ensure that these transfers were conducted in accordance with the contractual terms of the securitization, particularly in cases where the overall credit quality of the securitized loans or receivables has deteriorated.

The banking agencies prepared the "Interagency Guidance on Implicit Recourse in Asset Securitization Activities" to assist bankers and supervisors in assessing the types of actions that may, or may not, constitute implicit recourse. The guidance also outlines possible supervisory actions a banking organization's primary regulator may take upon determining that the banking organization has provided implicit recourse. The actions may result in increased regulatory capital requirements for the selling institution, including requiring regulatory capital to be held against the entire amount of assets sold, as well as the possible deduction of residual interests from regulatory capital. The guidance is located on the Board of Governors' web site at <http://www.federalreserve.gov/boarddocs/SRLETTERS/2002/SR0215a1.pdf>.

Questions and Answers on the Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations (SR 02-16)

On November 29, 2001, the Federal Reserve and the other federal banking agencies published a final rule on the Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations.² Since the rule became effective on January 1, 2002, the industry has raised several questions with regard to the appropriate application of certain aspects of the rule.

¹ For example, if excess spread in a revolving securitization is zero for three consecutive months, than the transaction begins to amortize earlier than scheduled in order to repay the asset-backed securities' principal before the portfolio's credit deterioration results in losses to investors.

² 66 Fed. Reg. 59614 (November 29, 2001) was issued jointly by the Federal Reserve, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision.

In response, the federal banking agencies jointly developed a question-and-answer document that provides interpretive guidance on some of these issues. The document is located on the Board of Governors' web site at <http://www.federalreserve.gov/boarddocs/SRLETTERS/2002/SR0216a1.pdf>. Further guidance will be provided as necessary.

Additional Information

All circulars and documents are available on the Internet through the Federal Reserve Bank of San Francisco's Internet site, at <http://www.frbsf.org/banking/letters>. Paper copies of the Board's notices (**SR 02-14, SR 02-15, SR 02-16**) are available from our Corporate Services Department. To request copies to be sent by mail, please call (415) 974-2060.

For additional information on SR 02-14 and SR 02-15, please contact our Banking Supervision and Regulation Department at (415) 974-2057.

For additional information on SR 02-16, please contact our Banking Supervision and Regulation Department at (415) 974-2936.

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