Thus, the insurance funds would not likely experience losses.

The fifth issue sought comment on whether the proposed low level recourse capital treatment would reduce transaction costs or otherwise help to facilitate the sale or securitization of banks' assets. The eight commenters that responded to this issue were all of the opinion that the low level capital treatment generally would help lower transaction costs and help facilitate securitization.

III. Final Rule

After considering the comments received, further deliberating on the issues involved, particularly the requirements of section 350 of the Riegle Act, and consulting with the other banking agencies, the FDIC is adopting a final rule amending its risk-based capital standards with respect to the treatment of low level recourse transactions. Specifically, the final amendment implements section 350 by reducing the risk-based capital requirements for all recourse transactions in which an FDIC-supervised bank contractually limits its recourse exposure to less than the full, effective risk-based capital requirement for the assets transferred.

This rule applies to low level recourse transactions involving all types of assets, including small business loans, commercial loans, multifamily housing loans, and residential mortgages. In this regard, the FDIC notes that previously under the risk-based capital standards certain residential mortgage loans transferred with recourse were excluded from risk-weighted assets if the institution did not retain significant risk of loss.[2] As proposed, this treatment would be superseded by the broader low level recourse rule that the FDIC is adopting.

Under the final low level recourse rule, an FDIC-supervised bank that contractually limits its maximum recourse obligation to less than the full effective risk-based capital requirement for the transferred assets would be required to hold risk-based capital equal to the contractual maximum amount of its recourse obligation. This requirement limits to one dollar the capital charge for each dollar of low-level recourse exposure. Under this dollar-for-dollar capital requirement, the capital charge for a 100 percent risk-weighted asset transferred with three percent recourse would be three percent of the amount of the transferred assets, rather than the eight percent previously required. Thus, a bank's risk-based capital requirement on a low level recourse transaction would not exceed the contractual maximum amount it could lose under the recourse obligation.

Under the final rule, an institution may reduce the dollar-for-dollar capital charge held against the recourse exposure on assets transferred with low level recourse for a transaction reported as a sale for Call Report purposes by the balance of any associated noncapital GAAP recourse liability account. In adopting this aspect of the final rule, the FDIC concurs with commenters that indicated that nonrecognition of the liability account would result in double coverage of the portion of the credit risk provided for in that account.

In applying the final rule, the FDIC will, as proposed, limit the risk-based capital requirement for an exposure to low level recourse retained in a transaction associated with a swap of mortgage loans for mortgage-related securities to the lower of the capital charge for the swapped mortgages or the combined capital charge for the low level recourse exposure and the mortgage-related securities, adjusted for any double counting.

In setting forth this final rule, the FDIC has considered the arguments that several commenters made for adopting for regulatory capital purposes the GAAP treatment for all assets sold with recourse, including those sold with low levels of recourse. Under such a treatment, assets sold with recourse in accordance with GAAP would have no capital requirement, but the GAAP recourse liability account would provide some level of protection against losses. Nevertheless, the FDIC continues to believe it would not be appropriate to adopt for regulatory capital purposes the GAAP treatment of recourse transactions, even if the transferring bank retains only a low level of recourse.

In the FDIC's view, the GAAP recourse liability account would be an inadequate substitute for maintaining capital at a level commensurate with the risks. One of the principal purposes of regulatory capital is to provide a cushion against unexpected losses. In contrast, the GAAP recourse liability account is, in effect, a specific reserve that is intended to cover only an institution's probable expected losses under the recourse provision. In this regard, the FDIC notes that the risk-based capital standards explicitly state that specific reserves created against identified losses may not be included in regulatory capital.

In addition, the amount of credit risk that is typically retained in a recourse transaction greatly exceeds the normal expected losses associated with the transferred assets. Thus, even though a transferring institution may reduce its exposure to potential catastrophic losses by limiting the amount of recourse it provides, it may still retain, in many cases, the bulk of the risk inherent in the assets. For example, an institution transferring high quality assets with a reasonably estimated expected loss rate of one percent that retains ten percent recourse in the normal course of business will sustain the same amount of losses it would have had the assets not been transferred. This occurs because the amount of exposure under the recourse provision is very high relative to the amount of expected losses. The FDIC believes that in such transactions the transferor has not significantly reduced its risk for purposes of assessing regulatory capital and should continue to be assessed regulatory capital as though the assets had not been transferred.

The FDIC is issuing this final rule now in order to implement section 350 of the Riegle Act in accordance with the statutory deadline. Consequently, the rule deals with only those portions of the NPR concerned with low level recourse transactions. The FDIC will continue to consider, on an interagency basis, other aspects of the NPR, as well as all aspects of the ANPR that was issued in conjunction with the NPR.

This final rule is effective April 27, 1995. However, FDIC-supervised banks may choose to apply the low level recourse rule when completing the risk-based capital schedule (Schedule RC–R) in their Reports of Condition and Income (Call Reports) for March 31, 1995.

IV. Regulatory Flexibility Act Analysis

The purpose of this final rule is to reduce the risk-based capital requirement on transfers of assets with low levels of recourse. Therefore, pursuant to section 605(b) of the Regulatory Flexibility Act, the FDIC hereby certifies that this rule will have a beneficial economic impact on small business entities (in this case, small banks) that sell assets with low levels of recourse.

[2] Under this treatment, a pool of residential mortgages that had been transferred with recourse was excluded from risk-weighted assets if the transferring institution did not retain significant risk of loss, *i.e.*, the institution's maximum contractual recourse exposure did not exceed its reasonably estimated probable losses on the transferred mortgages, and the institution established and maintained a recourse liability account equal to the maximum amount of its recourse obligation. Under the low level recourse rule, this type of sale transaction would effectively continue to be excluded from risk-weighted assets because of the size of the recourse liability account that must be maintained.