used as the basis of further leveraging and risk-taking by the parent banking organization. In deducting investments in, and advances to, certain subsidiaries from the parent's capital, the Federal Reserve expects the parent banking organization to meet or exceed minimum regulatory capital standards without reliance on the capital invested in the particular subsidiary. In assessing the overall capital adequacy of banking organizations, the Federal Reserve may also consider the organization's fully consolidated capital position.

Under the OTS capital guidelines, a distinction, mandated by FIRREA, is drawn between subsidiaries that are engaged in activities that are permissible for national banks and subsidiaries that are engaged in "impermissible" activities for national banks. Subsidiaries of thrift institutions that engage only in permissible activities are consolidated on a line-byline basis if majority-owned and on a pro rata basis if ownership is between 5 percent and 50 percent. As a general rule, investments, including loans, in subsidiaries that engage in impermissible activities are deducted in determining the capital adequacy of the parent. However, investments, including loans, outstanding as of April 12, 1989, to subsidiaries that were engaged in impermissible activities prior to that date are grandfathered and were phased-out of capital over a transition period that expired on July 1, 1994. During this transition period, investments in subsidiaries engaged in impermissible activities that have not been phased-out of capital were consolidated on a pro rata basis.

Nonresidential Construction and Land Loans

The three banking agencies assign loans for real estate development and construction purposes to the 100 percent risk category. Reserves or charge-offs are required, in accordance with examiner judgment, when weaknesses or losses develop in such loans. The banking agencies have no requirement for an automatic charge-off when the amount of a loan exceeds the fair value of the property pledged as collateral for the loan.

The OTS generally assigns these loans to the 100 percent risk category. However, if the amount of the loan exceeds 80 percent of the fair value of the property, that excess portion must be deducted from capital in accordance with a phase-in arrangement, which ended on July 1, 1994.

Mortgage-Backed Securities (MBS)

The three banking agencies, in general, place privately-issued MBSs in a risk category appropriate to the underlying assets but in no case to the zero percent risk category. In the case of privately-issued MBSs where the direct underlying assets are mortgages, this treatment generally results in a risk weight of 50 percent or 100 percent. Privately-issued MBSs that have government agency or government-sponsored agency securities as their direct underlying assets are generally assigned to the 20 percent risk category.

The OTS assigns privately-issued high quality mortgage-related securities to the 20 percent risk category. These are, generally, privately-issued MBSs with AA or better investment ratings.

At the same time, both the banking and thrift agencies automatically assign to the 100 percent risk weight category certain MBSs, including interest-only strips, residuals, and similar instruments that can absorb more than their pro rata share of loss. The Federal Reserve, in conjunction with the other banking agencies and the OTS, issued, on January 10, 1992, more specific guidance as to the types of "high risk" MBSs that will qualify for a 100 percent risk weight.

Assets Sold With Recourse

In general, recourse arrangements allow the purchaser of an asset to "put" the asset back to the originating institution under certain circumstances, for example if the asset ceases to perform satisfactorily. This, in turn, can expose the originating institution to any loss associated with the asset. As a general rule, the three banking agencies require that sales of assets involving any recourse be reported as financings and that the assets be retained on the balance sheet. This effectively requires a full leverage and risk-based capital charge whenever assets are sold with recourse, including limited recourse. The Federal Reserve generally applies a capital charge to any off-balance sheet recourse arrangement that is the equivalent of a guarantee, regardless of the nature of the transaction that gives rise to the recourse obligation.

An exception to this general rule for the three banking organizations involves pools of 1- to 4-family residential mortgages and to certain farm mortgage loans. Certain recourse transactions involving these assets are reported in the bank Call Report as sales, and, thus, are not included in the asset base used in calculating the Tier 1 leverage ratio. For risk-based capital purposes, however, the amount of such mortgages

sold with recourse is generally treated as an off-balance sheet guarantee, and assessed a capital charge.

In general, the OTS also requires a full risk-based capital charge against assets sold with recourse. However, in the case of assets sold with recourse, the OTS limits the capital charge to the lesser of the amount of recourse or the actual amount of capital that would otherwise be required against that asset, that is, the normal full capital charge.

Some securitized asset arrangements involve the issuance of senior and subordinated classes of securities against pools of assets. When a bank originates such a transaction by placing loans that it owns in a trust and retaining any portion of the subordinated securities, the banking agencies require that capital be maintained against the entire amount of the asset pool. When a bank acquires a subordinated security in a pool of assets that it did not originate, the banking agencies assign the investment in the subordinated piece to the 100 percent risk-weight category. The Federal Reserve carefully reviews these instruments to determine if additional reserves, asset write-downs, or capital are necessary to protect the bank.

The OTS requires that risk-based capital be maintained against the entire amount of the asset pool in both of the situations described in the preceding paragraph. Additionally, the OTS applies a capital charge to the full amount of assets being serviced when the servicer is required to absorb credit losses on the assets being serviced.

On May 25, 1994, the three banking agencies and the OTS, under the auspices of the FFIEC, sought public comment on various aspects of the capital treatment of recourse transactions by publishing a Notice of Proposed Rulemaking (NPR) and an Advance Notice of Proposed Rulemaking (ANPR), which is a more preliminary step in the formal rulemaking process. The comment period ended July 25, 1994.

The NPR proposed to amend the banking agencies' risk-based capital guidelines by:

- (1) Reducing the risk-based capital charge for "low level" recourse arrangements to an amount equal to the maximum contractual recourse obligation;
- (2) Requiring equivalent capital treatment of recourse arrangements and direct credit substitutes that provide first dollar loss protection. This would increase the capital assessment for *first loss* standby letters of credit and purchased subordinated interests that