holding companies' risk-based capital ratios, however, assets sold with recourse that have been removed from the balance sheet in accordance with GAAP are included in risk-weighted assets. Consequently, both banks and bank holding companies generally are required to maintain capital against the full risk-weighted amount of assets transferred with recourse.

In cases where an institution retains a low level of recourse, the amount of capital required under the Board's risk-based capital guidelines could exceed the institution's maximum contractual liability under the recourse agreement. This can occur in transactions in which a banking organization contractually limits its recourse exposure to less than the full effective risk-based capital requirement for the assets transferred—generally, 4 percent for mortgage assets and 8 percent for most other assets.

The Federal Reserve and the other federal banking agencies have long recognized this anomaly in the risk-based capital guidelines. On May 25, 1994, the banking agencies, under the auspices of the Federal Financial Institutions Examination Council (FFIEC), issued a Notice of Proposed Rulemaking (NPR) (59 FR 27116) that was aimed principally at amending the risk-based capital guidelines to limit the capital charge in low level recourse transactions to an institution's maximum contractual recourse liability. The proposal for these types of transactions would effectively result in a dollar capital charge for each dollar of low level recourse exposure, up to the full effective risk-based capital requirement on the underlying assets.

The proposal requested specific comment on whether an institution should be able to use the balance of the GAAP recourse liability account to reduce the dollar-for-dollar capital charge for the recourse exposure on assets transferred with low level recourse in a transaction recognized as a sale both under GAAP and for regulatory reporting purposes. In addition, the proposal indicated that the capital requirement for an exposure to low level recourse retained in a transaction associated with a swap of mortgage loans for mortgage-related securities would be 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.

The NPR also addressed other issues related to recourse transactions, including equivalent capital treatment of recourse arrangements and direct credit substitutes that provide first dollar loss protection and definitions for ''recourse'' and associated terms such as ''standard representations and warranties.'' The NPR was issued in conjunction with an Advance Notice of Proposed Rulemaking (ANPR) that outlined a possible alternative approach to deal comprehensively with the capital treatment of recourse transactions and securitizations. The comment period for the NPR and ANPR ended on July 25, 1994.

During the agencies' review of the comments received, the Riegle Act was signed into law on September 23, 1994. Section 350 of the Act requires the federal banking agencies to issue regulations limiting, as of March 22, 1995, the amount of risk-based capital an insured depository institution is required to hold for assets transferred with recourse to the maximum amount of recourse for which the institution is contractually liable. In order to meet the statutory requirements of section 350, the Federal Reserve is now issuing a rule that puts into final form only those portions of the NPR dealing with low level recourse transactions.

Comments Received

In response to the NPR and ANPR, the Federal Reserve Board received letters from 36 public commenters. Of these respondents, 27 addressed issues related to the NPR's proposed low level recourse capital treatment. These commenters included 13 banking organizations, including 11 multinational and regional banking organizations, one community banking organization, and one foreign banking organization; eight trade associations; two law firms; one government-sponsored agency; and three other commenters. Of these 27 respondents, 23 specifically provided a favorable overall assessment of the low level recourse proposal. In general, these respondents viewed the low level proposal as a way of rationally correcting an anomaly in the existing risk-based capital rules so that institutions would not be required to hold capital in excess of their contractual liability.

Ten of the commenters stated that, while the proposed low level recourse capital treatment was a positive step, it still would result in too high of a capital requirement for assets sold with limited recourse. These respondents, which included eight of the thirteen banking organizations and two of the eight trade associations, expressed the view that the banking agencies should adopt the GAAP treatment of assets sold with recourse for purposes of calculating the regulatory capital ratios. These commenters maintained that the GAAP recourse liability account provides adequate protection against the risk of loss on assets sold with recourse, obviating the need for additional capital.

The NPR specifically sought comment on five issues related to the proposed capital treatment of low level recourse transactions. Thirteen of the 27 respondents commented on the first issue, which concerned the treatment of the GAAP recourse liability account established for assets sold with recourse reported as sales for regulatory reporting purposes. These 13 commenters favored reducing the capital requirement for low level recourse transactions by the balance of its GAAP recourse liability account—which would continue to be excluded from an institution's regulatory capital. In their view, not taking this account into consideration would result in double coverage of the portion of the risk provided for in that account.

Fourteen commenters, including five banking organizations and five trade associations, responded to the second issue, which sought comment on whether a dollar-for-dollar capital requirement would be too high for low level recourse transactions. Eleven commenters indicated that such a capital charge would be too high since it was unlikely that an institution would incur losses up to its maximum contractual liability. Two others responded that whether the capital treatment was too high depended upon the credit quality of the underlying asset pool and the structure of the securitization. One commenter stated that the dollar-for-dollar capital charge would not be too onerous.

The third issue dealt with ways of demonstrating that the dollar-for-dollar capital requirement might be too high and possible methods for reducing this requirement without jeopardizing safety and soundness. The eight commenters on this issue indicated that historical analysis, examiner review, and ''depression scenario'' stress testing would show whether the capital requirement would be too high relative to historical losses.

The fourth issue concerned ways the banking agencies could handle the increased probability of loss to the insurance fund if less than dollar-for-dollar capital is maintained against low

transferor must establish a separate liability account equal to the estimated probable losses under the recourse provision (GAAP recourse liability account).