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The ABCs of Securitization: Regulatory Issues

Anthony R. G. Nolan
K&L Gates

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Agenda

- Regulatory environment
- Complex Structured Finance Transactions
- Non-traditional Mortgage Products
- Subprime Lending Update
- Securitizations under Basel I and II
- Selected Accounting issues

Regulatory Environment

- Main themes:
  - Enron's shadow
  - Regulation AB
  - Subprime blow-up
- Predatory lending initiatives
- Mortgage fraud
- Operational risk concerns

Complex Structured Finance Transactions

- Interagency statement – issued December 2006
- To whom does it apply?
  - US banks and thrifts and branches and agencies of foreign banks
  - Registered broker dealers
  - Registered investment advisers
- Recognizing elevated complex structured finance transactions
  - No economic substance or circular transfers of risk
  - Questionable accounting, regulatory or tax objectives
  - Undocumented material agreements
  - Disproportionate compensation to arranger
- Not applicable to “standard securitizations”, e.g.
  - credit cards securitizations
  - asset-backed commercial paper programs
  - hedging programs involving “plain vanilla” derivatives
  - collateralized loan obligations

Complex Structured Finance Transactions

- Approval and Diligence Procedures
  - Diligence level must be commensurate with risk
  - Appropriate levels of control and management personnel
- Documentation
  - Reflect factors considered by senior management
  - Verify that bank made required disclosures
  - Verify adequacy of process
- Independent Review Function
  - Verify implementation of policies and procedures
  - audit department or independent compliance function
  - May assess substance of decisions not just process

Non-Traditional Mortgage Products Guidance

- Applies to banks and thrifts
- Scope
  - Applies to negative amortization and interest-only mortgage products
  - Does not apply to reverse mortgages, fully amortizing residential mortgages or first-lien HELOCs
- Loan Terms and Underwriting Standards
  - Credible analysis of each borrower's repayment capacity
  - Safety and soundness considerations
- Risk Management Practices
  - Strong risk management standards,
  - capital levels commensurate with the risk,
  - allowance for loan and lease losses that reflect collectibility
  - Control Procedures:
    - reporting to management,
    - monitoring and early detection of problems,
    - due diligence and monitoring of third parties.

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Non-Traditional Mortgage Products Guidance

- Consumer Protection
  - recommended practices to ensure borrowers have enough information to understand loan terms and associated risks.
  - Lenders should present clear and balanced information as to benefits and the risks of nontraditional mortgage products *before* time of application.
- Similar guidance for managing risks associated with HELOCs that contain interest-only features
- Suggested disclosure, best practices

Predatory Lending Legislation

- Recent state and county legislation
  - Ohio Homebuyers' Protection Act (enacted 06/06)
  - Tennessee Home Protection Act of 2006 (enacted 06/06)
  - Rhode Island Home Loan Act (enacted 07/06)
- Status of federal preemption
  - Talent-Nelson amendment (effective 10/06)
  - Ney-Kanjorsky bill v. Miller-Watt-Frank bill
  - Update on bank regulatory preemption
    - OCC v. OTS
    - Distinguish bank as trustee

Recent Litigation/Regulatory Action

- TILA litigation
  - Chevy Chase Bank
  - First Horizon Bank
- Bankers Life Insurance Company v. Credit Suisse First Boston
- Ohio Attorney General threat of litigation
- New York attorney general subpoenas

Basel II Securitizations (NPR)
Scope of Basel II – US Banks

- Basel I currently applies to all US financial institutions
- Basel II is proposed for banks and BHC with (i) $250 BB consolidated total assets <u>OR</u> (ii) $10BB consolidated total on-balance sheet foreign exposure
- Qualified institutions may opt in to Basel II regime
- Basel IA is proposed to bridge competitive disadvantages between Basel I Basel II institutions
- Only the "advanced approach" is currently planned for Basel II institutions, but other alternatives are being considered
- Market risk capital rules are broader in coverage, applying to any applicable institution with aggregate trading assets and liabilities ≥ 10% of total assets, or ≥ $1 billion

Basel II Securitizations (NPR)
Operational Requirements for securitization

- Underlying exposures may be excluded from balance sheet only if operational requirements for securitization are met
- Operational requirements for traditional securitization:
  - GAAP true sale
  - Transfer to 3d party of credit risk associated with the underlying exposures
  - Clean-up calls must be "eligible"
- Special considerations for synthetic securitization:
  - Credit risk mitigant consists of financial collateral, eligible credit derivative or eligible guarantee (enforceability opinion required in all cases)
  - Credit derivative terms, pricing, yield may not be change based on credit deterioration of underlying exposures
- Implicit Support - Regulators can put all securitization exposures back on balance sheet as if not securitized if the originator supports securitization in excess of its contractual obligation

Basel II Securitizations (NPR)
Definition of Securitization Exposure

- Securitization is defined broadly to include any transaction that involves tranching of credit risk:
- All or part of credit risk is transferred to third parties
- Credit risk is separated into two or more tranches
- Performance of securitization exposure depends on performance of underlying exposures
- All or most of the underlying exposures are financial exposures

Basel II Securitizations (NPR)
Risk-Weighting Approaches and Deductions

- Ratings-based Approach ("RBA")
  - Exposure must be rated by an NRSRO or have an inferred rating
  - Originators need 2 ratings, investors only 1
  - Risk weights depend on rating, seniority and granularity
  - Comparison to ratings-based approach in the Basel I rules
- Internal assessment approach ("IAA")
  - Only for qualifying securitization exposures to ABCP programs
  - Bank must obtain regulator's prior written approval to use of IAA
- Supervisory Formula Approach ("SFA")
  - 7 inputs must be calculable on an ongoing basis, including capital requirement for all underlying exposures as if held on balance sheet
  - SFA formula imposes a 56-bp floor
- Deduction from capital
  - Gain on sale and credit enhancing interest only strips
  - Securitization exposures that do not qualify for RBA, IAA or SFA.

Basel II Securitizations (NPR)
Hierarchy of Risk-Weighting Approaches and Deductions

- Deduct from Tier 1 capital (i) after-tax gain on sale and (ii) credit enhancing interest only strips greater than 25% of tier 1 capital
- Apply the RBA to any other securitization exposure that has the requisite ratings
- For an ABCP program securitization exposure that does not qualify for the RBA, apply either IAA or the SFA to the exposure if either can be used
- For a securitization exposure not described above, apply the SFA if the bank can calculate the SFA risk factors for the securitization exposure and the underlying exposures
- For a securitization exposure not described above, deduct the exposure pro rata from tier 1 and tier 2 capital

Basel II Securitizations (NPR)

Some Exceptions to the Hierarchy of Approaches

- Multiple Exposures to Single Securitization
  - The risk-based capital requirements for all securitization exposures held by a single bank associated with a single securitization cannot be greater than the sum of (i) KIRB for the underlying exposures and (ii) the bank's expected credit loss for the underlying exposures
- MBS Interest-only strips
  - Mortgage-backed interest-only strips cannot have a risk weight below 100% regardless of rating (often AAA). This reflects volatility and prepayment risk
- Securitization of non-IRB assets
  - A bank with securitization exposure to assets that are not wholesale, retail, securitization or equity exposures must apply RBA or deduct the exposure from capital. E.g. music or film receivables
- Eligible Servicer Cash Advances
  - Banks servicing securitized residential mortgage loans are not required to hold capital against the undrawn portion of eligible servicer cash advances

Basel II Securitizations (NPR)
Treatment of Overlapping Exposures

- ABCP Programs
  - A bank with multiple duplicative securitization exposures to an ABCP program must apply the risk-based capital treatment to the position that results in the highest capital requirements
  - E.g. include program wide credit enhancement and pool-specific liquidity facilities
- Securitization exposures resulting from loan swaps
  - A bank with securitization exposure in the form of a MBS or participation interest resulting from a mortgage loan swap with recourse must bifurcate the position into the retained recourse obligation and the percentage of the MBS or participation interest not covered by the recourse
  - The bank must separately calculate the risk-based capital requirement for each component
  - The total risk-basec capital requirement is capped at the risk based capital requirement for the underlying exposures as if they were held directly on balance sheet

Basel II Securitizations (NPR)
Synthetic Securitization

- First Loss and Super Senior Tranches.
  - Deduct from regulatory capital unless (i) the position qualifies for use of the RBA or (ii) the bank and the position qualified for use of the SFA and (in the case of a first loss position) a portion of the position was above KIRB.

- Nth-to-Default Tranches.
  - Protection buyer must determine its risk-based capital requirement as if it had only synthetically securitized the n − 1 underlying exposures with the lowest capital requirement that would otherwise have applied) and had obtained no credit risk mitigant on the other underlying exposures.
  - Investing bank may use the RBA if the securitization position has the requisite external or inferred ratings. Otherwise it must calculate its risk-weighted asset amount for the derivative based on the sum of the risk-based capital requirements of the individual underlying exposures to which it is exposed, up to a maximum of 100 percent. In the case of an nth-to-default derivative that is not represent a first-to-default exposure, the calculation excludes the n-1 underlying exposures with the lowest risk-based capital requirements.

Basel II Securitizations (NPR)
Comparison of RBA for Basel I and Basel II

Securitisation Risk Weights				
Tranche Rating	Basel II RBA (Senior Tranche)	Basel II RBA (Base Case)	Basel II RBA (Non-Granular)	Basel I ABS Capital Rule
AAA/Aaa	7%	12%	20%	20%
AA/AA2	8%	15%	25%	20%
A/A2	12%	20%	35%	50%
BBB/Baa2	60%	75%	75%	100%
BB/Ba2		450%		200%
B/B2		1 for 1		

Selected Securitization Accounting Concepts

- Off-balance sheet treatment of Issuing SPV
- FAS 140
  - QSPE – Limitations
  - Transfer of financial assets – surrender of control
  - True sale opinion role, issues
- FIN 46R
  - Variable interest entities
  - Primary beneficiary – majority of expected losses

Thank you!

Anthony R.G. Nolan
+1.212.536.4843
Anthony.Nolan@KLGates.com

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American Bar Association Section of Business Law ABC's of Securitization

June 21, 2007

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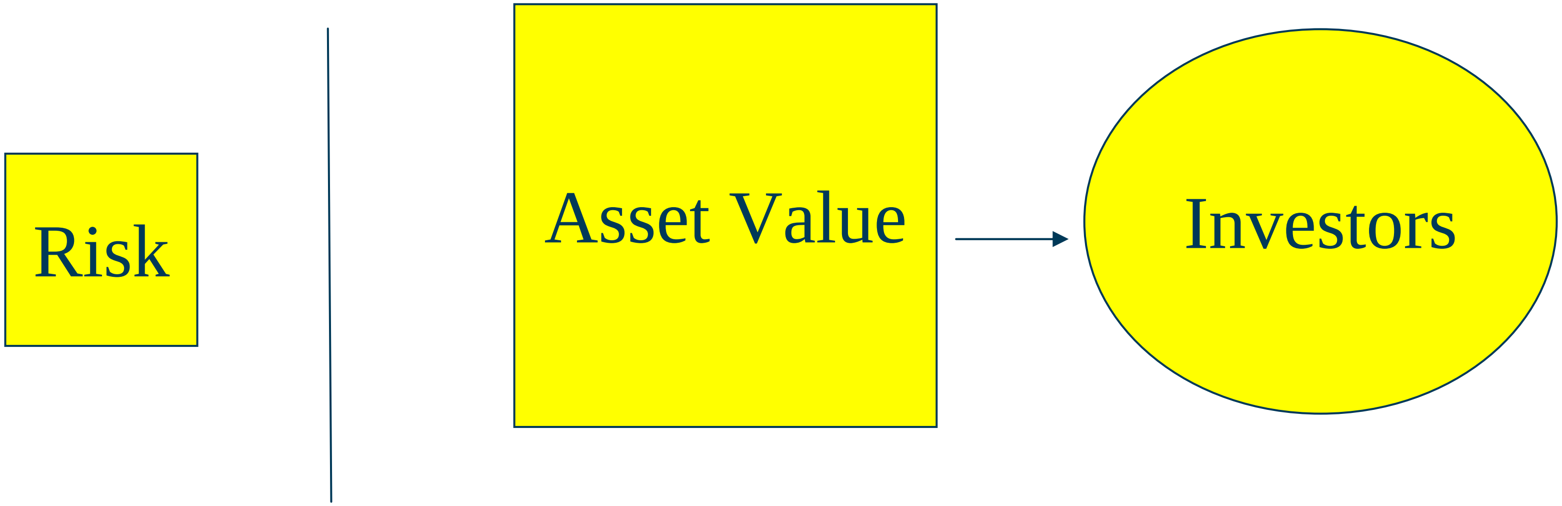
Securitization Basics

Teresa Wilton Harmon
Sidley Austin LLP
One South Dearborn Street
Chicago, Illinois 60603
tharmon@sidley.com
www.sidley.com

A. Definition of Securitization

- Securitization involves isolating a stream of payments and issuing a security based on that stream of payments.
- Model:



Direct Loan

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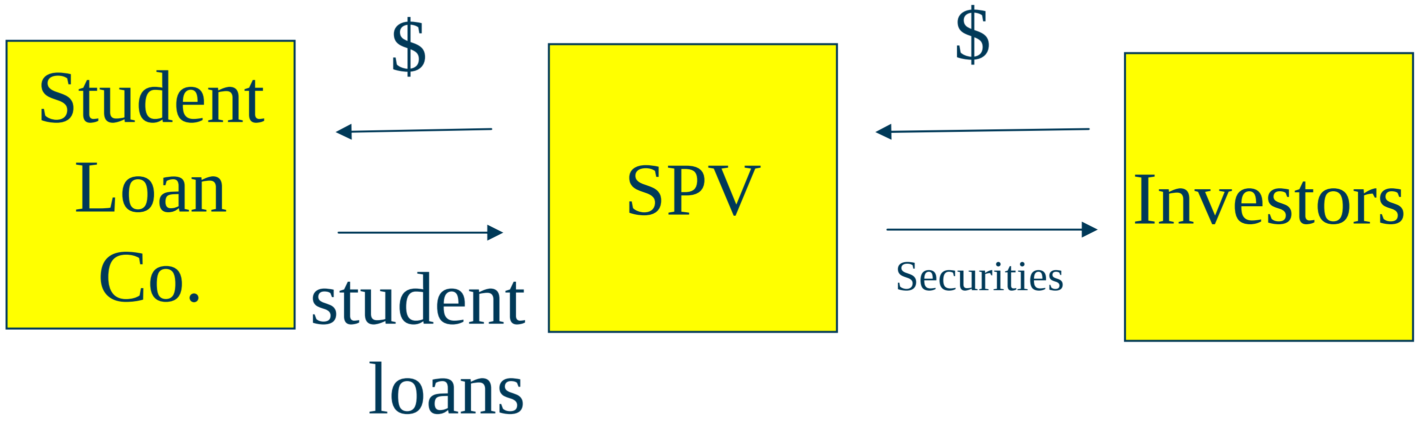
Securitization (Direct to Investors)



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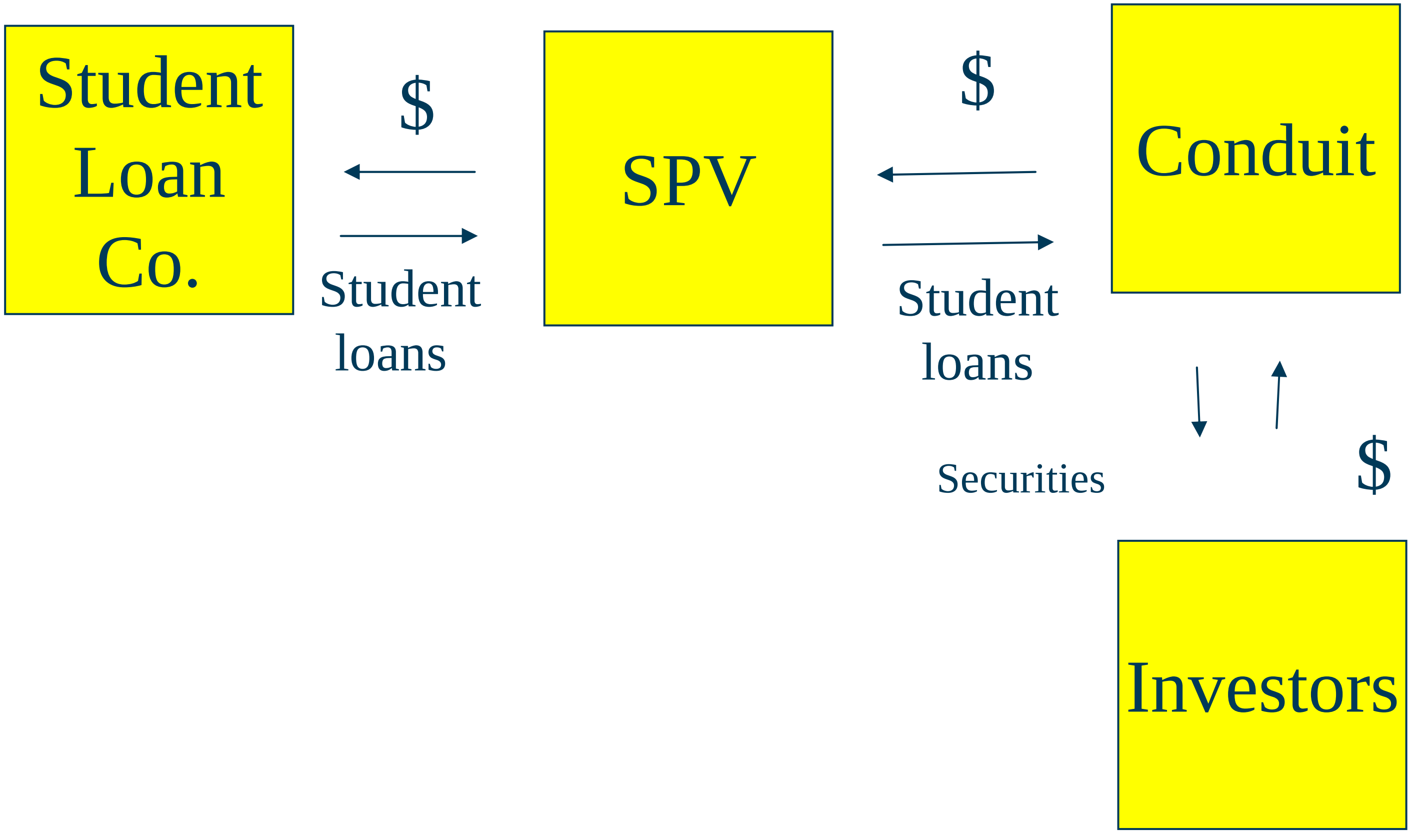
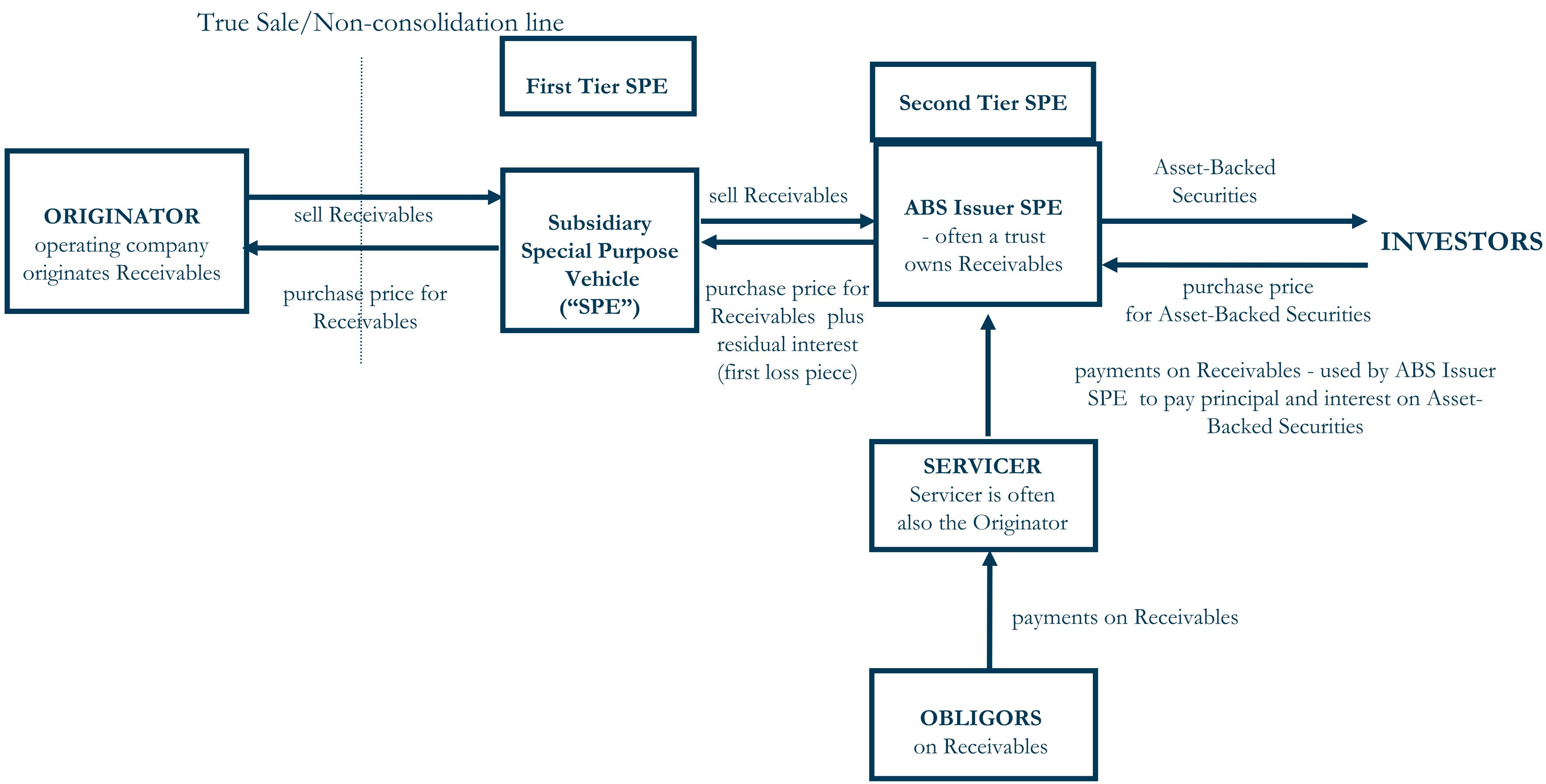
Securitization (Conduit)

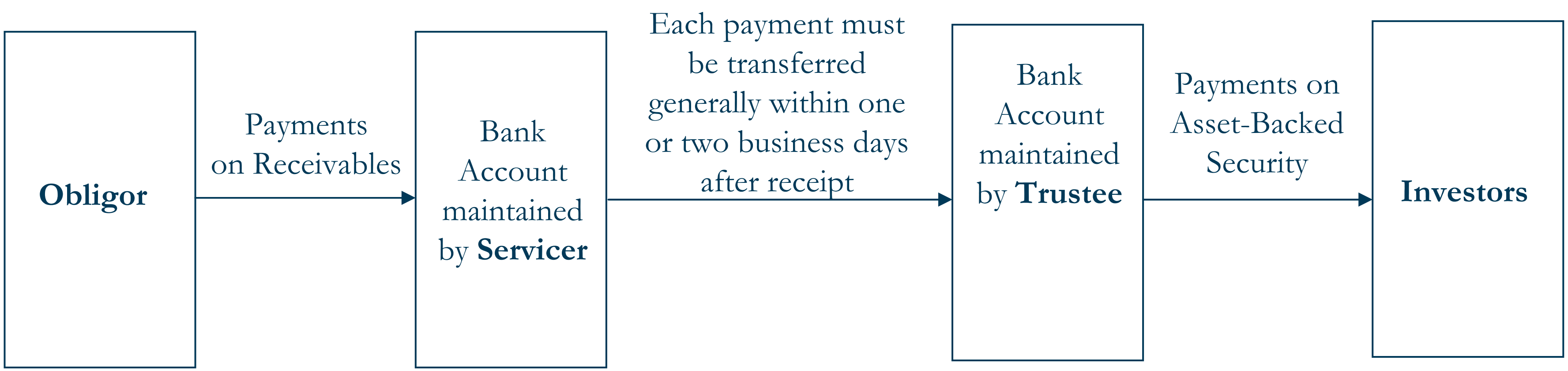


A. Typical Securitization Structure



Advantages to Investors: If the Subsidiary SPE or the ABS Issuer SPE owns the Receivables, the Receivables will not be property of the Originator. Consequently, creditors of the Originator will not receive any proceeds from the Receivables. There should be no disruption of payments to Investors.

Typical Flow of Payments in a Securitization



C. Core Principles

1. Basic Terminology

- ***Originator*** — The entity that originates the Receivables. For example, an Originator could be a lending institution that originates loans or a commercial entity (such as a company that sells electricity) whose sales result in trade receivables (the amounts owed by the purchasers of the electricity).

- ***Receivable*** — An obligation to pay money. For example, a Receivable could be a loan or an amount owed by a commercial customer to a seller of a product. The Receivable must convert into cash.

- ***Obligor*** — The person or entity that is obligated to pay the Receivable.

- ***Servicer*** — The entity that collects payments on the Receivables. The Originator and the Servicer are usually the same person.

- ***Special Purpose Entity*** — The entity that purchases the Receivables from the Originator and therefore owns the Receivables. The Special Purpose Entity will issue the Asset-Backed Securities. Because of its limited activities, the Special Purpose Entity is very unlikely to become insolvent and is referred to as "bankruptcy remote."

2. Reasons for Using Securitization Structures

(a) ***Only means available.*** If the Originator has a bad credit rating, securitization may be the only means of financing available to the Originator.

(b) ***Lower cost of financing.*** Even if the Originator has alternative methods of financing available to it, the cost of a securitization may be lower than the cost of those alternative methods. If the Asset-Backed Securities have a rating that is higher than the credit rating of the Originator, the yield required by the investors in the Asset-Backed Securities will most likely be lower than the yield required on debt of the Originator.

(c) ***Alternative source of financing***. Some Originators use securitization to make sure they will have an additional source of financing in case their other sources of financing become unavailable for any reason or become more expensive.

3. Separation of the Credit Risk of the Originator from the Credit Risks of the Receivables

(a) ***General.*** In the context of a typical secured lending transaction, the investor is exposed to the credit risk of the Originator, even if the obligations of the Borrower are secured by a security interest in collateral. Upon the insolvency of the Borrower, the insolvency court will have the power to stop payments on the obligations and to prevent the investors from taking action on the collateral to satisfy the Borrower's obligations. Under certain circumstances, the insolvency court may allow other creditors of the Borrower to receive proceeds from the collateral. Eventually, the investors will receive the benefit of the collateral.

In a securitization, the objective is to transfer the Receivables (the “collateral”) to a Special Purpose Entity so that the Receivables are owned by the Special Purpose Entity and not by the Originator. If this objective is accomplished, then in the context of insolvency proceedings of the Originator, the insolvency court will not have any control over the Receivables and will not have any power to affect the cash flow arising from the Receivables. The cash flow arising from the Receivables will, without interruption, continue to be applied to make payments on the Asset-Backed Securities. The result is that investors are exposed to the credit risk of the Receivables and not the credit risk of the Originator.

(b)True Sale. The type of transfer that accomplishes this separation is referred to as a "true sale" or "absolute transfer." A true sale in a securitization may be contrasted to a transfer of collateral in a secured lending transaction, which is a transfer for the purpose of creating security. What constitutes a true sale will vary from jurisdiction to jurisdiction. In some jurisdictions, it is sufficient if the form of the transaction is a sale. In other jurisdictions (such as the United States), the substance of the transaction must be that of a sale—i.e., the transfer must move the burdens and benefits of owning the Receivables from the transferring entity to the receiving entity. Section 541 of the Bankruptcy Code covers what constitutes property of the bankruptcy estate. Factors considered in the true sale analysis include:

- Fair Purchase Price
- Arms Length Terms
- No recourse
- Whether assets remain sold once sold
- Whether risk of loss transfers

(c) What is a Special Purpose Entity and Why is a Special Purpose Entity Used in a Securitization? A Special Purpose Entity is an entity whose activities are limited to owning the Receivables and issuing the Asset-Backed Securities supported by the Receivables. The cash flow arising from the Receivables is calculated to be sufficient to pay interest and principal on the Asset-Backed Securities. In addition, the operating expenses of a Special Purpose Entity usually can be identified at the time of its creation and therefore can also be covered by the cash flow arising from the Receivables. Because of its limited activities, a Special Purpose Entity is unlikely to become insolvent and is therefore referred to as "bankruptcy remote." Consequently, the risk of an investor in Asset-Backed Securities is intended to be solely the risk of owning the Receivables. By way of contrast, the Originator is an operating company that will continue to incur new liabilities. Because there is no certainty or high degree of probability that the Originator's current or future liabilities will be paid, the Originator is not "bankruptcy remote."

Caution should be paid to creating the Special Purpose Entity in a way that is consistent with securities laws, including the Investment Company Act of 1940. Special Purpose Entities are usually structured to satisfy one of the exemptions from registration under the '40 Act.

(d) ***Substantive Consolidation.*** The Special Purpose Entity must be legally separate from the Originator. Under the legal theory of "substantive consolidation," the Special Purpose Entity could be considered to be part of the Originator if the Special Purpose Entity is operated in a manner that leads third parties to reasonably believe that the Special Purpose Entity is merely a part of the Originator. If the Special Purpose Entity is consolidated with the Originator, then the Receivables may become available to other creditors of the Originator as discussed above.

4. Substantive Consolidation

(a) ***In a bankruptcy context the disregard of two or more legal entities such that the assets and liabilities of such entities are merged and the inter-entity claims are disregarded is called substantive consolidation.***

(i) Although such relief is not specifically authorized by any section of the Bankruptcy Code or by any Bankruptcy Rule, it is universally accepted that Bankruptcy Courts may order substantial consolidation by virtue of their general equitable powers. E.g., Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp. Inc.), 810 F.2d 270, 276 (D.C. Cir. 1987).

(ii) In a non-bankruptcy context, similar relief is sometimes granted using the label of "piercing the corporate veil." E.g., In re 1438 Meridian Place, N.W., Inc.,15 B.R., 89, 96 (Bankr. D.D.C. 1981).

(iii) Since there are no definitive rules as to when substantive consolidation should be granted, generally the issues that are considered include the following:

(A) Did creditors of the first entity reasonably rely on the availability of assets of the second equity to pay their obligations?

(B) Should creditors of the second entity have reasonably believed that the second entity's assets would be available to pay obligations of the first?

(C) Are the assets and liabilities of both entities so hopelessly entangled that separation is impracticable in any event?

(iv) To invoke substantive consolidation, some courts have found that there are two central factual inquiries that must be made: (a) the effect of consolidation on the creditors of each entity and (b) the nature of the relationship between the entities sought to be consolidated. A finding on the first question may be controlling. Other courts have determined that while "elements" to substantive consolidation may be gleaned from the case law, the paramount criterion is the economic prejudice of contained debtor separateness versus the economic prejudice of consolidation. In re Luth, 28 B.R. 564 (Bankr. D. Idaho 1983).

(v) In analyzing the nature of the relationship among affiliated entities, the following common factors have been considered:

(A) the parent corporation owns all or a majority of the capital stock of the subsidiary;

(B) The parent corporation and the subsidiary have common directors or officers;

(C) The parent corporation finances the subsidiary;

(D) The parent corporation subscribed to all of the capital stock of the subsidiary or otherwise causes its incorporation or formation;

(E) The subsidiary has grossly inadequate capital;

(F) The parent corporation pays the salaries or expenses or losses of the subsidiary;

(G) The subsidiary has substantially no business except with the parent corporation or no assets except those conveyed to it by the parent corporation;

(H) In the papers of the parent corporation and in the statements of its officers "the subsidiary" is referred to as such or as a department or division;

(I) The directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take direction from the parent corporation; and

(J) The formal legal requirements of the subsidiary as a separate and independent entity are not observed. Fish v. East., 114 F.2d 177, 191 (10th Cir. 1940)

(vi) Other courts have stressed that the purpose of the substantive consolidation is to ensure the equitable treatment of all creditors and that the critical factors are (a) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit or (b) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors. In re Augie/Restivo Baking Co., 860 F.2d 515 (2d Cir. 1988).

(vii) Stated a little differently, other courts have stressed creditor reliance and prejudice as the key factors in any consolidation analysis, i.e., if a party opposing substantive consolidation establishes that (a) it relied on the separate credit of one of the entities to be consolidated, and (b) it will be prejudiced by substantive consolidation, then substantive consolidation may be ordered only if the "demonstrated benefits of consolidation 'heavily' outweigh the harm." Eastgroup Properties v. Southern Motel Ass'n, Ltd., 935 F.2d 245, 249 (11th Cir. 1991).

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5. Transferring the Receivables

(a) ***The Originator Must Take Certain Actions in order to Transfer the Receivables to the Special Purpose Entity.*** The action required will vary by jurisdiction. In the United States for certain types of Receivables, a simple filing in a government office is sufficient to effect a valid transfer that will move the Receivables from the Originator to the Special Purpose Entity. In many European jurisdictions before special securitization legislation was enacted, it was necessary to give notice of the transfer to the Obligor in order to effect a valid transfer. In some jurisdictions, it may be necessary to obtain the consent of the Obligor to the transfer. When there are many Receivables, the requirement to give notices or obtain consents is usually very burdensome administratively and expensive. In addition, many Originators do not want their Obligors to know that the Receivable has been transferred.

(b) ***The Receivables Must Be Free of any Claims by Other Parties.*** It is possible that the Originator has previously transferred the Receivables to a third party or has previously granted a security interest in the Receivables in favor of a third party. In addition, governmental liens may encumber the Receivables. Any such prior claim on the Receivables makes the Receivables ineligible for securitization because the cash flow arising from such Receivables will go to the third party rather than to the Special Purpose Entity. Methods for determining whether such prior claims exist will vary by jurisdiction.

(c) The requirements of the UCC must be satisfied. Securitization transactions include multiple sales and pledges of financial assets. Sales of financial assets such as accounts receivable, promissory notes and payment intangibles are included in the security interests subject to the rules of Article 9 of the UCC. As a result, every sale and every pledge within a securitization structure must be analyzed to determine what actions, if any, are required to attach, perfect and obtain a first priority security interest.

Sales and pledges of accounts are generally perfected by the filing of a financing statement.

Sales of promissory notes and payment intangibles are generally automatically perfected but because of the risk that a sale transaction might be re-characterized as a disguised loan and because many securitization sales also contain backup security interests, it is usually prudent to file a financing statement for affiliate sales of promissory notes or payment intangibles.

6. "Weakest Link in the Chain": Structuring the Securitization Transaction

   (a) ***Each Step in the Structure Must Satisfy the Rating Agency's Requirements for the Rating Level Sought.*** The transfer of the Receivables from the Originator to the Special Purpose Entity is just the first step in the structure of the securitization that must satisfy the rating agency. Once the transfer of the Receivables is effected, each step in the process of collecting the cash flow arising from the Receivables and eventually paying the cash flow out on the Asset-

Backed Securities must satisfy the requirements of the rating agency for the rating level sought for the Asset-Backed Securities.

(b) ***Management Information Systems of the Servicer; Servicer May Not Hold Collections.*** The Servicer must have adequate management information systems to track collections on the Receivables and the status of the Receivables.

Unless the Servicer has a credit rating equivalent to the rating of the Asset-Backed Securities, the Servicer must deposit collections within one or two business days after receipt on the Receivables into an account maintained by the Special Purpose entity. If the Servicer were permitted to hold these collections, then those collections would be exposed to the credit risk of the Servicer. Such exposure would lower the rating of the Asset-Backed Securities to the rating of the Servicer.

(c) ***Ability to replace the Servicer.*** If the Receivables are of a type that only one Servicer or very few Servicers can service, then the rating of the Asset-Backed Securities may be affected by the credit rating of the Servicer. In such a case, the insolvency of the Servicer would result in an interruption of the servicing of the Receivables.

On the other hand, if the Receivables are of a type for which there are many other servicers available, then the rating of the Servicer should not affect the rating of the Asset-Backed Securities. In such a case, if the

Servicer becomes insolvent, a new servicer will be available and there will be only a minor disruption to the collection of cash flow in the change from the old Servicer to the new servicer.

(d) ***Role of the Trustee.*** The Trustee will act to enforce the rights of the investors against the Special Purpose Entity and the Servicer. The Trustee's credit rating need not be as high as the rating of the Asset-Backed Securities, again because there are many other institutions who could replace the Trustee if it became unable to act.

7. Economic Substance of Asset-Backed Securities

(a) ***Debt.*** Asset-Backed Securities are, in economic substance, indebtedness. The payment of principal and interest on the indebtedness are funded from the cash flow arising on the Receivables. The anticipated cash flow on the Receivables is sufficient to pay a fee to the Servicer, to pay the other operating expenses of the Special Purpose Entity and to pay the principal and interest due. Normally, the anticipated cash flow exceeds those amounts so that even after giving effect to losses on the Receivables, the remaining cash flow is still sufficient to pay such amounts. To determine the likely amount of the losses, the rating agency looks at the historical losses experienced on the Receivables. Cash flow on the Receivables that remains available after the payment of the amounts described above goes back to the Originator.

(b) ***Unpredictability of Payments on the Asset-Backed Securities.*** Because the timing of payments on the Receivables cannot be predicted with great accuracy, the timing of payments of principal on the Asset- Backed Securities cannot be predicted with great accuracy. This is the major point that distinguishes Asset-Backed Securities from other capital markets indebtedness and affects the yield that investors require on Asset-Backed Securities. Various structural devices may be used to make certain the timing of payments of principal.

(c) ***Rating of the Asset-Backed Securities.*** As discussed above, the credit rating of the Originator does not normally limit the rating of the Asset-Backed Securities. The rating of the Asset-Backed Securities will depend on the credit risk of the Receivables and the amount of the credit enhancement used in the securitization structure. The higher the credit rating of an Asset-Backed Security, the lower the yield on the Asset-Backed Security required by investors. The savings from a lower yield must be compared to the cost of the credit enhancement used to obtain the higher rating.

Implications of the Impending Elimination of Canadian Withholding Tax on Interest Payments

The Canadian government recently announced that it would soon eliminate withholding tax on arm's length payments of interest to US and other non-residents of Canada. Once implemented, this will significantly affect how Canadians raise debt capital, both for straight corporate borrowings as well as for securitization and other structured finance products.

This article will discuss the current state of cross-border financing between Canada and the US, the pending revision to the Canada/US tax treaty to eliminate withholding taxes on cross-border interest payments, the complementary amendment to Canada's domestic tax legislation to eliminate withholding tax on arm's length interest payments to all other non-residents of Canada, the implications of this change for the Canadian, US and other foreign capital markets, and actions which participants in these markets may wish to consider in preparation for what is likely to be a significant increase in cross-border borrowing and securitization involving interest-bearing Canadian obligations.

One of the most difficult hurdles to overcome in providing capital from one country to another is often the tax regime of the recipient country. Canada is a case in point. When funds are loaned cross-border to a Canadian borrower, or Canadian interest-bearing or rental receivables or bonds are sold to non-residents, Canada's tax legislation imposes a 25% withholding tax on any interest or rent that is paid to the non-resident. While this rate is frequently reduced under a bilateral tax treaty, it rarely falls below 10%, and usually constitutes too great an economic burden to justify raising foreign capital. Nevertheless, tax-effective cross-border securitizations and loans are getting done, relying on a variety of exemptions, interpretations and risk allocation decisions.

With relatively little fanfare, non-interest bearing Canadian trade receivables have for more than 20 years been transferred to US, UK or European multi-seller conduits, or purchased by US or other non-resident factoring companies. Along the way, numerous issues have been identified and resolved, including the following:

- If the asset purchase agreement is properly documented, withholding tax should not apply to the cross-border payment of collections (including that portion representing the purchase price discount). It is common to exclude from the sale any part of the receivables that represents financing charges or default interest (which could attract withholding tax).

- If the Canadian seller is appointed the off-shore purchaser's servicer or collection agent, special care is required to ensure that the purchaser does not thereby acquire a "permanent establishment" in Canada, and consequently become subject to Canadian tax. If the US purchaser is an US limited liability company, even greater care is required since LLCs may become subject to Canadian tax simply through having an agent (e.g., a servicer) in Canada even if the agent's activities do not result in the LLC-purchaser having a Canadian permanent establishment.

- Although the federal sales tax component (known as GST) of a receivable can be assigned, the Canadian tax authorities have taken the position that an assignment will not be effective if only an interest (e.g., a co-ownership interest) in the GST receivable is assigned rather than the entire receivable. On the other hand, certain provincial sales taxes are simply not assignable, and are often excluded from cross-border sales.

- Perfecting a sale of Quebec receivables can present special challenges. Perfecting through registration (rather than notice) is possible only if the Quebec receivables constitute a "universality", a complex concept relating to classes of receivables. As well, Quebec receivables should be transferred under a single sale of present and future receivables rather than, for example, by daily assignments (since a registration is required for each separate transfer). In certain circumstances it may be possible to conclude that perfection in Quebec is not necessary on the basis that Quebec law does not apply to the transaction.

- If a subordinated note is given for the balance of the receivables' purchase price, this can give rise to a deemed dividend issue for the Canadian seller. In some transactions, it has been possible to avoid a note by paying the full purchase price for the Canadian receivables in cash, and reducing the cash portion that is paid in connection with a foreign affiliate's concurrent securitization. Alternatively, the deemed dividend issue will not arise if the purchaser is unrelated to the seller (e.g., an ABCP conduit) or if the seller holds at least 1% of any class of the purchaser's shares (and the remaining shares are held by a related entity) – however, this structure may raise other tax issues depending on the Canadian seller's particular circumstances.

More challenging yet can be the cross-border securitization of *interest-bearing* receivables, and cross-border loans or bonds. While most consumer loans, such as credit card receivables and residential mortgages, will attract withholding tax if made or sold cross-border, this does not apply to all corporate loans. For example, a major franchisor was able to provide low cost funding to its Canadian franchisees by arranging for franchise loans, which were subsequently assigned to a US-based ABCP conduit. As well, a Canadian small business lender regularly sells its Canadian loans to its US parent for eventual securitization in the US. These transactions avoid Canadian withholding tax by complying with three basic elements of Canada's withholding tax exemption for *long-term* debt:

1. The borrower must be a corporation resident in Canada (or a partnership having only such corporations as partners) - not an individual, trust or partnership having one or more individual partners.

2. With some exceptions (including acceptable events of default) mandatory repayments in the first five years must not exceed 25% of the loan.

3. Borrower and lender must be unrelated and deal at arm's length within the meaning of those terms under the Income Tax Act (Canada).

This long-term debt model has been successfully adapted to also securitize *short-term* corporate loan receivables off-shore without attracting withholding tax. For example, a portfolio of short-term Canadian floorplan loans, and a separate group of subordinate Canadian CMBS tranches, have each been sold to Canadian special purpose securitization vehicles that obtained funding by issuing secured bonds to US or Euromarket investors under a structure that satisfied the long-term withholding tax exemption. In another transaction, a Canadian corporation borrowed long-term funds from an off-shore ABCP conduit and on-lent the proceeds to a Canadian single-seller securitization trust that held short-term assets. In these transactions, it was necessary to deal with early amortization events under a Canadian securitization that did not match the events of default under the corresponding cross-border loan, with the Canadian tax authority's policies regarding back-to-back loan structures, and with entity level tax issues affecting the Canadian securitization vehicle.

A number of other, less frequently used, withholding tax exemptions have also been utilized in appropriate circumstances. For example, certain royalties, purchase money debt obligations between US sellers and Canadian purchasers, and government-guaranteed obligations may be sold or issued cross-border free of withholding tax. As well, a large number of US and other foreign tax-exempt organizations are exempt from Canadian withholding tax, and have been used to place subordinated tranches of Canadian commercial mortgage-backed securities in the US free of withholding tax.

There are a number of reasons why the issuance of Canadian bonds or asset-backed securities in the US capital markets on a withholding tax-free basis could offer significant advantages over purely Canadian domestic offerings:

- Canadian lenders and investors have traditionally been more risk adverse than their US counterparts. While the market has become less conservative, it can still be a challenge to place lower rated and subordinate ABS tranches in Canada. As well, many Canadian investors require bullet rather than amortizing structures.

- Canadian investors are not familiar with a number of complex asset classes that have become relatively common in the US, such as student loans. The ultimate success of securitizing these and other less common receivable types may depend on placing at least a portion of such offerings in the US.

- Concerns about adequate liquidity in the Canadian ABS market and its capacity to absorb additional ABS product would be relieved by increased access to the deeper and broader US investor base.

The good news is that withholding tax will soon cease to pose an impediment to issuing Canadian debt or securitizing Canadian interest-bearing receivables in the US and other foreign capital markets. In its annual budget speech on March 19, 2007, the Canadian federal government announced that its on-going negotiations with the US to amend the Canada/US tax treaty were almost complete. When ratified by the US senate and confirmed by Canadian legislation, the amended treaty will:

- Eliminate withholding tax on interest payments between **arm’s length** residents of Canada and the US (including LLCs).

- Over a three year period, eliminate withholding tax on interest payments between **non-arm’s length** residents of Canada and the US.

In addition, once the US treaty amendment comes into effect, Canada will also amend its domestic tax legislation to eliminate withholding tax on interest paid by Canadians to **arm’s length** residents of **every other country in the world**. This will be done unilaterally, without first amending Canada’s other tax treaties.

Eliminating Canadian withholding tax will have a profound effect on where Canadians raise their funds, both for corporate and consumer borrowings, as well as through securitization and other structured products. We can expect to see cross-border financings of all types, including short term loans, operating loans, asset-backed facilities, and warehouse and liquidity facilities. We will also see increased securitization of Canadian corporate and consumer debt, such as commercial and residential mortgages, credit card obligations and car loans that will now be able to economically access the deep investor base of the US and other foreign capital markets.

As to timing, the budget speech said only that negotiations on the Canada/US treaty are "expected to conclude in the very near future". It's clear that eliminating withholding tax on arm's length interest has become a government priority, and that we will soon see a Canadian capital market unhampered by the restraining effects of withholding taxes.

Similar revisions to the Australian withholding tax regime led to the securitization of billions of dollars of Australian residential mortgages in the US. We can expect similar results for various types of Canadian consumer and commercial interest-bearing receivables.

A number of issues should be kept in mind in connection with non-resident purchases of Canadian receivables or debt offerings, both before and after the withholding tax repeal becomes effective:

- The non-Canadian lender's/investor's investment powers, liquidity agreements and other applicable documents (including rating agency conditions) should be reviewed and revised as needed to permit the purchase of foreign currency obligations.

- Legal counsel should become familiar with Canadian perfection requirements, the bankruptcy regime applicable to Canadian originators, and the unique format of Canadian true sale opinions.

- Cross-border transactions should be structured to avoid the non-resident lender or investor becoming subject to Canadian income, capital or sales taxes.

- Transaction documents may require revisions to adapt them for cross-border use, such as to reflect applicable Canadian statutes and Canada's one-step asset transfer structure.

- The non-resident will want to consider whether and how best to hedge the currency risk posed by acquiring Canadian dollar obligations.

The North American Free Trade Agreement permitted the duty-free flow of most goods and services between Canada and the US. With the forthcoming revision to the Canada's tax legislation, and the convergence of various perfection, securities and accounting regimes, we may soon see a Canadian capital market unhampered by the restraining effects of withholding taxes.

June 18, 2007

Martin Fingerhut
Blake, Cassels & Graydon LLP
Toronto, Canada
416-863-2638
martin.fingerhut@blakes.com

CROSS-BORDER SECURITIZATION

Cross-border securitization is all about moving capital from one jurisdiction to another. Investors (capital providers) in one country seek to put their funds to work in a second country; while originators of securitizable assets (capital seekers) in the second country wish to access funds from the first. If the only issue were the usual supply-and-demand market dynamics, cross-border trades in capital would be comparable to those in goods and services, and significantly more extensive than currently experienced. However, factors other than market give and take are at work when it comes to transferring money across borders. Although Canada has entered into free trade agreements with a number of countries - the U.S., Mexico, Chile, Israel and Costa Rica - these arrangements expressly exclude most "taxation measures", and as well leave untouched a myriad of regulatory, accounting and legal obstacles to inter-country transfers of capital. This paper will survey a number of the issues that require attention in connection with any cross-border asset securitization transaction.

From a regulatory standpoint, Canada, like most jurisdictions, has enacted legislation designed to protect its citizens and the country's well-being, and these laws apply in varying degrees to the activities of foreign enterprises which interact with Canadians. The regulatory landscape is not static – constant monitoring is necessary to keep current with changes in the law, its interpretation and regulators' attitudes, and how each is affected by changes in technology. A number of regulatory issues that currently impede or otherwise affect cross-border securitization are discussed in greater detail in the balance of this article.

Banking. Canada has historically maintained a relatively restrictive attitude to non-Canadian banks that wish to carry on business in Canada. Until recently, only Canada and Mexico, among modern trading countries, required a foreign bank to establish a bank subsidiary in order to carry on business domestically. As well, Canada has long limited foreign ownership of widely held Canadian banks to 10%. However, for competitive and other reasons, this attitude is beginning to change. Since June 1999, reputable and financially sound foreign financial institutions have been able to establish Canadian branch operations under a lighter regulatory regime (particularly when the operations do not accept deposits). And more recent legislation has increased foreign ownership limits (to 20% or greater depending on the size of the Canadian institution), and introduced measures that facilitate strategic alliances between Canadian and foreign financial institutions.

While Canada's previously restrictive foreign bank entry rules are being relaxed, this does not mean that non-Canadian financial institutions were formerly precluded from supplying funds to Canadian borrowers, including special purpose entities engaged in securitization. A recognized distinction exists between a foreign bank that carries on business in Canada on the one hand, and one that conducts business with Canadians on the other. So long as the foreign institution's activities (negotiation, document execution, etc.) take place beyond the Canadian border, it may well fall outside the Canadian regulatory net. For example, foreign banks have for many years participated in loan facilities in favour of Canadian borrowers, one example being Wells Fargo's small business loan program under which the U.S. bank provided funding to Canadian borrowers utilizing off-shore based telemarketing and other procedures sanctioned by Canadian regulatory authorities. Similarly, for over 20 years U.S., European and Asian financial institutions have been devising regulatory-friendly structures to purchase Canadian receivables and asset-backed securities, and to provide their loan, enhancement and liquidity facilities to Canadian securitization entities.

Securities Activities. An often posed question concerns the ability of a U.S. or other foreign investment dealer to place securities with a Canadian investor. In a securitization context, the issue is whether the dealer must comply with Canadian securities laws when selling asset-backed securities to Canadian residents. In this regard, Canada regulates securities on a provincial/territorial basis, and any offering of securities to Canadians would be subject to the laws of the particular province or territory in which the purchaser resides. For example, the *Securities Act* of Ontario provides that a foreign dealer which engages "in Ontario in the business of trading" in securities as principal or agent must register with the Ontario Securities Commission. Although this legislative framework appears similar to that followed in the federal banking sector as discussed above, provincial securities regulators have traditionally adopted the more aggressive position that Canadian securities legislation applies to foreign entities that deal with Canadians, even if the foreign entity conducts its activities solely beyond the Canadian border. This attitude has been supported by case law which, for example, indicates that any telephone solicitation from outside Ontario to an Ontario resident would constitute engaging in Ontario in the business of trading in securities. As to the possibility of utilizing the Internet to side step local securities regulation, provincial securities regulators recently took the position that two major U.S. brokerage firms contravened Canadian securities laws by permitting Canadians to open on-line trading accounts without the firms being registered pursuant to Canadian securities legislation. In settling these allegations, the foreign firms agreed to apply for registration in those Canadian jurisdictions where they have clients and to each pay the Canadian regulators the sum of C$800,000.

Where it is concluded that Canadian securities legislation applies to a sale of foreign securities, whether asset-backed or otherwise, a number of issues must be considered in addition to whether the foreign dealer need be registered (or rely on a registration exemption, such as utilizing a registered Canadian intermediary). Some of these other issues include: (i) whether a Canadian-style prospectus is required; (ii) where an exemption from the prospectus requirement is available, whether the offering document constitutes an "offering memorandum" for purposes of Canadian securities legislation and if so, whether the document and any Canadian "wraparound" comply with applicable Canadian securities requirements; (iii) whether the offering document, or a report of any Canadian-based trades, need be filed, and the amount of any applicable fees; (iv) the nature of any resale restrictions, within or outside Canada, applicable to securities sold pursuant to a prospectus exemption; (v) the nature of any on-going reporting obligations to which the issuer of the securities is subject under Canadian securities laws; and (vi) the implications of using advertisements or other marketing materials in Canada (including foreign-generated research reports).

Insurance. An asset-backed transaction often requires enhancement in order to obtain the desired ratings from credit rating agencies. In the U.S. and Europe, enhancement facilities are commonly provided by monoline insurance companies, which take on a portion of the issue's risk through a financial guaranty insurance policy. Insurance companies which carry on business in Canada do not offer insurance of this type because (i) federally registered Canadian insurers were in 1991 directed by their primary Canadian regulator, the Office of the Superintendent of Financial Institutions ("OSFI"), to refrain from writing these policies out of a concern that the resultant risk could lead to "catastrophic financial losses" and threaten the insurers' solvency, and (ii) non-Canadian insurers require a federal order to "in Canada insure a risk", which order will not currently be given in connection with financial guaranty insurance.

Canadian securitization transactions have recently begun to exhibit an increasing appetite for foreign-based enhancement facilities due to the growing size of Canadian issues and the recent departure of a number of traditional enhancement providers. This has led several U.S. and other foreign insurers to attempt to negotiate the regulatory and tax maze involved in providing financial guaranty insurance to a Canadian transaction from outside Canada. So long as the foreign insurer does not carry on business in Canada, OSFI will not object to the insurer credit-enhancing a Canadian transaction through a policy of financial guaranty insurance. It can be seen that OSFI's position in the insurance sector coincides with its attitude to foreign-based lenders that provide loan facilities to Canadian borrowers. The provincial position is more complex since, in addition to requiring an insurer to be licensed in order to carry on an insurance business in the province, a number of provincial statutes also decree that certain specified types of conduct, which may at first glance appear unavoidable, will deem the insurer to be undertaking insurance activities in the province, and thereby trigger a licensing requirement. For example, the Ontario *Insurance Act* provides that a foreign insurer which engages in any of the following activities will be deemed to be carrying on the business of insurance in that province:

- issuing or delivering a policy of insurance in Ontario
- collecting, receiving or negotiating for, or causing to be collected, received or negotiated for, any insurance premium in Ontario
- in Ontario inspecting a risk
- adjusting in Ontario a loss under an insurance contract

- prosecuting or maintaining in Ontario an action or proceeding in respect of an insurance contract
- in respect of an insurance contract the subject of which is an insurable interest of an Ontario resident, allowing the contract to be signed, countersigned, issued or delivered in Ontario.

Notwithstanding this federal/provincial labyrinth, a number of foreign insurance companies have devised programs to issue financial guaranty insurance policies in respect of Canadian securitization transactions without running afoul of Canadian licensing requirements. In some cases, the insurance product is provided by way of a cross-border credit derivative; other insurers have offered a cross-border loan facility backed by an off-shore insurance policy; while another approach involves conducting the necessary due diligence ("inspecting the risk") outside of Canada or through a registered insurance broker located in Canada. With so much demand, and so many willing players, it is not surprising that OSFI and provincial insurance regulators are currently considering a regulatory scheme that will accommodate the provision of this insurance product by non-Canadian insurers without requiring them to be licensed under Canadian insurance legislation.

The most difficult hurdle to overcome in providing capital from one country to another is often the onerous tax regime of the recipient country. Canada is a case in point. When funds are loaned cross-border to a Canadian borrower, or interest-bearing or rental receivables are sold to a non-resident, Canadian domestic tax legislation currently imposes a relatively high 25% withholding tax on the amount of interest or rent paid to the non-resident. While this rate is frequently reduced by bilateral treaty, it rarely falls below 10%, and usually constitutes too great an economic burden to justify raising foreign capital. Nevertheless, tax-effective cross-border securitizations are getting done, relying on a variety of exemptions, interpretations and risk allocation decisions. This issue is elaborated on in a companion article that discusses Canada's recent initiative to eliminate withholding tax on cross-border interest payments.

The hallmark of a successful securitization is one that isolates securitized assets from the originator's credit risk. The creditors of an insolvent originator must not be able to look to the securitized assets in competition with asset-backed investors. Accordingly, a "true sale" of such assets, free from the possibility that they will form part of the transferor's bankruptcy estate, is a necessary ingredient of the standard securitization. In a cross-border transaction, investors from one jurisdiction should not assume that the bankruptcy regime with which they are familiar will determine their ability to have exclusive access to the cash flow of foreign-based receivables. For example, U.S. attorneys are concerned that their courts could deny sale treatment to a securitization under which the transferor maintains significant credit risk in respect of the transferred assets, and they normally ensure the requisite isolation by utilizing a two-step structure – an initial non-recourse sale to a subsidiary, and a subsequent structured sale with the requisite recourse to the securitization vehicle. Under Canadian and U.K. jurisprudence, however, seller recourse is not determinative as to whether the underlying assets have been sold, since courts in these jurisdictions are concerned less about the "economic realities" of a transaction and more about the intentions of the parties as demonstrated by the legal documentation utilized to reduce their intentions into writing. Accordingly, Canadian cross-border securitizations are able to employ a more user-friendly one-step sale structure in order to transfer the securitized assets into foreign capital markets.

A number of other matters must be kept in mind when structuring a cross-border securitization. Among the most common:

- Perfection. Certain jurisdictions, including the U.S. and Canada, require that a sale of receivables be "perfected", through registration or actual notice, in order to protect the transaction from the creditors of the seller and various third parties. Difficult issues may arise when considering the appropriate approach to be followed, such as in connection with the Quebec Civil Code which requires prior notice to the account debtor unless the receivables form a "universality" (a not perfectly understood concept relating to classes of receivables).
- Anti-Assignment Provisions. Not all jurisdictions have provisions comparable to the U.S. Uniform Commercial Code under which a sale of receivables remains valid notwithstanding that the underlying contract prohibits the sale. In Ontario and Quebec, for example, a purported assignment made in the face of a clear prohibition to the contrary will be void as against the obligor.
- Currency Issues. Where the cash flow from Canadian-denominated receivables are dedicated to fund the payment of principal and interest under securities issued in a foreign capital market, an obvious currency risk arises. Rating agencies often require that such risk be hedged, and a number of devices have been used for this purpose.

The international securitization market has raised trillions of dollars through the securitization of receivables and other assets. A small but growing percentage of this market encompasses the transfer of these assets from one jurisdiction to another and the reciprocal transfer of capital. This paper has explored a number of legal, regulatory, tax and business issues which must be addressed when structuring a cross-border transaction of this nature.

June 18, 2007

Martin Fingerhut
Blake, Cassels & Graydon LLP
Toronto, Ontario, Canada
416-863-2638
martin.fingerhut@blakes.com

7. To determine whether Terry Keith Hammond willfully and/or repeatedly violated § 73.1015 of the Commission's rules by failing to provide full and complete responses and documents as directed by letters of inquiry issued by the staff of the Enforcement Bureau on June 14, 2004, and August 10, 2004; and

8. To determine, in light of the evidence adduced pursuant to the foregoing designated issues, whether the captioned application for renewal of the license for Station KBKH(FM) should be granted, or denied.

Copies of the Order to Show Cause, Notice of Opportunity for Hearing, and Hearing Designation Order are being sent by certified mail, return receipt requested, to Terry Keith Hammond. To avail himself of the opportunity to be heard, Terry Keith Hammond, pursuant to § 1.91(c) and § 1.221 of the Commission's rules, 47 CFR 1.91(c) and 47 CFR 1.221, in person or by his attorney, must within 30 days of the release of this Order, file in triplicate a written notice of appearance stating an intention to appear on the date fixed for the hearing and present evidence on the issues specified in this Order. Terry Keith Hammond pursuant to § 73.3594 of the Commission's rules, 47 CFR 73.3594, shall give notice of the hearing within the time and in the manner prescribed in 47 CFR 73.3594, and shall advise the Commission of the publication of such notice as required by 47 CFR 73.3594(g).

Federal Communications Commission.

Marlene H. Dortch,

Secretary.

[FR Doc. E6–16217 Filed 10–3–06; 8:45 am]

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DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

[Docket No. 06–11]

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

[Docket No. OP–1246]

FEDERAL DEPOSIT INSURANCE CORPORATION

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

[No. 2006–35]

NATIONAL CREDIT UNION ADMINISTRATION

Interagency Guidance on Nontraditional Mortgage Product Risks

AGENCIES: Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Office of Thrift Supervision, Treasury (OTS); and National Credit Union Administration (NCUA).

ACTION: Final guidance.

SUMMARY: The OCC, Board, FDIC, OTS, and NCUA (the Agencies), are issuing final Interagency Guidance on Nontraditional Mortgage Product Risks (guidance). This guidance has been developed to clarify how institutions can offer nontraditional mortgage products in a safe and sound manner, and in a way that clearly discloses the risks that borrowers may assume.

FOR FURTHER INFORMATION CONTACT: *OCC:* Gregory Nagel, Credit Risk Specialist, Credit and Market Risk, (202) 874–5170; or Michael S. Bylsma, Director, or Stephen Van Meter, Assistant Director, Community and Consumer Law Division, (202) 874–5750.

Board: Brian Valenti, Supervisory Financial Analyst, (202) 452–3575; or Virginia Gibbs, Senior Supervisory Financial Analyst, (202) 452–2521; or Sabeth I. Siddique, Assistant Director, (202) 452–3861, Division of Banking Supervision and Regulation; Kathleen C. Ryan, Counsel, Division of Consumer and Community Affairs, (202) 452–3667; or Andrew Miller, Counsel, Legal Division, (202) 452–3428. For users of Telecommunications Device for the Deaf (''TDD'') only, contact (202) 263–4869.

FDIC: Suzy S. Gardner, Examination Specialist, (202) 898–3640, or April Breslaw, Chief, Compliance Section, (202) 898–6609, Division of Supervision and Consumer Protection; or Ruth R. Amberg, Senior Counsel, (202) 898–3736, or Richard Foley, Counsel, (202) 898–3784, Legal Division.

OTS: William Magrini, Senior Project Manager, Examinations and Supervision Policy, (202) 906–5744; or Fred Phillips-Patrick, Director, Credit Policy, (202) 906–7295; or Glenn Gimble, Senior Project Manager, Compliance and Consumer Protection, (202) 906–7158.

NCUA: Cory Phariss, Program Officer, Examination and Insurance, (703) 518–6618.

SUPPLEMENTARY INFORMATION:

I. Background

The Agencies developed this guidance to address risks associated with the growing use of mortgage products that allow borrowers to defer payment of principal and, sometimes, interest. These products, referred to variously as ''nontraditional'', ''alternative'', or ''exotic'' mortgage loans (hereinafter referred to as nontraditional mortgage loans), include ''interest-only'' mortgages and ''payment option'' adjustable-rate mortgages. These products allow borrowers to exchange lower payments during an initial period for higher payments during a later amortization period.

While similar products have been available for many years, the number of institutions offering them has expanded rapidly. At the same time, these products are offered to a wider spectrum of borrowers who may not otherwise qualify for more traditional mortgages. The Agencies are concerned that some borrowers may not fully understand the risks of these products. While many of these risks exist in other adjustable-rate mortgage products, the Agencies concern is elevated with nontraditional products because of the lack of principal amortization and potential for negative amortization. In addition, institutions are increasingly combining these loans with other features that may compound risk. These features include simultaneous second-lien mortgages and the use of reduced documentation in evaluating an applicant's creditworthiness.

In response to these concerns, the Agencies published for comment proposed Interagency Guidance on Nontraditional Mortgage Products, 70 FR 77249 (Dec. 29, 2005). The Agencies proposed guidance in three primary areas: ''Loan Terms and Underwriting Standards'', ''Portfolio and Risk Management Practices'', and ''Consumer Protection Issues''. In the first section, the Agencies sought to ensure that loan terms and underwriting standards for nontraditional mortgage loans are consistent with prudent lending practices, including credible consideration of a borrower's repayment capacity. The portfolio and risk management practices section outlined the need for strong risk management standards, capital levels commensurate with the risk, and an allowance for loan and lease losses (ALLL) that reflects the collectibility of the portfolio. Finally, the consumer protection issues section recommended practices to ensure consumers have clear and balanced information prior to making a product choice. Additionally, this section described control systems to ensure that actual practices are consistent with policies and procedures.

The Agencies together received approximately 100 letters in response to the proposal.[1] Comments were received from financial institutions, trade associations, consumer and community organizations, state financial regulatory organizations, and other members of the public.

II. Overview of Public Comments

The Agencies received a full range of comments. Some commenters applauded the Agencies' initiative in proposing the guidance, while others questioned whether guidance is needed.

A majority of the depository institutions and industry groups that commented stated that the guidance is too prescriptive. They suggested institutions should have more flexibility in determining appropriate risk management practices. A number observed that nontraditional mortgage products have been offered successfully for many years. Others opined that the guidance would stifle innovation and result in qualified borrowers not being approved for these loans. Further, many questioned whether the guidance is an appropriate mechanism for addressing the Agencies' consumer protection concerns.

A smaller subset of commenters argued that the guidance does not go far enough in regulating or restricting nontraditional mortgage products. These commenters included consumer organizations, individuals, and several community bankers. Several stated these products contribute to speculation and unsustainable appreciation in the housing market. They expressed concern that severe problems will occur if and when there is a downturn in the economy. Some also argued that these products are harmful to borrowers and that borrowers may not understand the associated risks.

Many commenters voiced concern that the guidance will not apply to all lenders, and thus federally regulated financial institutions will be at a competitive disadvantage. The Agencies note that both State financial regulatory organizations that commented on the proposed guidance—the Conference of State Bank Supervisors (CSBS) and the State Financial Regulators Roundtable (SFRR)—committed to working with State regulatory agencies to distribute guidance that is similar in nature and scope to the financial service providers under their jurisdictions.[2] These commenters noted their interest in addressing the potential for inconsistent regulatory treatment of lenders based on whether or not they are supervised solely by state agencies. Subsequently, the CSBS, along with a national organization representing state residential mortgage regulators, issued a press release confirming their intent to offer guidance to State regulators to apply to their licensed residential mortgage brokers and lenders.[3]

III. Final Joint Guidance

The Agencies made a number of changes to the proposal to respond to commenters' concerns and to provide additional clarity. Significant comments on the specific provisions of the proposed guidance, the Agencies'' responses, and changes to the proposed guidance are discussed as follows.

Scope of the Guidance

Many financial institution and trade group commenters raised concerns that the proposed guidance did not adequately define ''nontraditional mortgage products''. They requested clarification of which products would be subject to enhanced scrutiny. Some suggested that the guidance focus on products that allow negative amortization, rather than interest-only loans. Others suggested excluding certain products with nontraditional features, such as reverse mortgages and home equity lines of credit (HELOCs). Those commenting on interest-only loans noted that they do not present the same risks as products that allow for negative amortization. Those that argued that HELOCs should be excluded noted that they are already covered by interagency guidance issued in 2005. They also noted that the principal amount of these loans is generally lower than that for first mortgages. As for reverse mortgages, the commenters pointed out that they were developed for a specific market segment and do not present the same concerns as products mentioned in the guidance.

To address these concerns, the Agencies are clarifying the types of products covered by the guidance. In general, the guidance applies to all residential mortgage loan products that allow borrowers to defer repayment of principal or interest. This includes all interest-only products and negative amortization mortgages, with the exception of HELOCs. The Agencies decided not to include HELOCs in this guidance, other than as discussed in the Simultaneous Second-Lien Loans section, since they are already covered by the May 2005 Interagency *Credit Risk Management Guidance for Home Equity Lending.* The Agencies are amending the May 2005 guidance, however, to address the consumer disclosure recommendations included in the nontraditional mortgage guidance.

The Agencies decided against focusing solely on negative amortization products. Many of the interest-only products pose risks similar to products that allow negative amortization, especially when combined with high leverage and reduced documentation. Accordingly, they present similar concerns from a risk management and consumer protection standpoint. The Agencies did, however, agree that reverse mortgages do not present the types of concerns that are addressed in the guidance and should be excluded.

Loan Terms and Underwriting Standards

Qualifying Borrowers

The Agencies proposed that for all nontraditional mortgage products, the analysis of borrowers' repayment

[1] Nine of these letters requested a thirty-day extension of the comment period, which the Agencies granted.

[2] Letter to J. Johnson, Board Secretary, *et al.* from N. Milner, President & CEO, Conference of State Bank Supervisors (Feb. 14, 2006); Letter to J. Johnson, Board Secretary, *et al.*, from B. Kent, Chair, State Financial Regulators Roundtable.

[3] Media Release, CSBS & American Association of Residential Mortgage Regulators, ''CSBS and AARMR Consider Guidance on Nontraditional Mortgage Products for State-Licensed Entities'' (June 7, 2006), available at *http://www.csbs.org/Content/NavigationMenu/PublicRelations/PressReleases/News_Releases.htm.* The press release stated:

The guidance being developed by CSBS and AARMR is based upon proposed guidance issued in December 2005 by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration.

The Federal guidance, when finalized, will only apply to insured financial institutions and their affiliates. CSBS and AARMR intend to develop a modified version of the guidance which will primarily focus on residential mortgage underwriting and consumer protection. The guidance will be offered to State regulators to apply to their licensed residential mortgage brokers and lenders.

capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. In addition, the proposed guidance stated that for products that permit negative amortization, the repayment analysis should include the initial loan amount plus any balance increase that may accrue from negative amortization. The amount of the balance increase is tied to the initial terms of the loan and estimated assuming the borrower makes only the minimum payment.

Generally, banks and industry groups believed that the proposed underwriting standards were too prescriptive and asked for more flexibility. Consumer groups generally supported the proposed underwriting standards, warning that deteriorating underwriting standards are bad for individual borrowers and poor public policy.

A number of commenters suggested that industry practice is to underwrite payment option adjustable-rate mortgages at the fully indexed rate, assuming a fully amortizing payment. Yet several commenters argued that this standard should not be required when risks are adequately mitigated. Moreover, many commenters opposed assuming a fully amortizing payment for interest-only loans with extended interest-only periods. They argued that the average life span of most mortgage loans makes it unlikely that many borrowers will experience the higher payments associated with amortization. Additionally, many commenters opposed the assumption of minimum payments during the deferral period for products that permit negative amortization on the ground that this assumption suggests that lenders assume a worst-case scenario.

The Agencies believe that institutions should maintain qualification standards that include a credible analysis of a borrower's capacity to repay the full amount of credit that may be extended. That analysis should consider both principal and interest at the fully indexed rate. Using discounted payments in the qualification process limits the ability of borrowers to demonstrate sufficient capacity to repay under the terms of the loan. Therefore, the proposed general guideline of qualifying borrowers at the fully indexed rate, assuming a fully amortizing payment, including potential negative amortization amounts, remains in the final guidance.

Regarding interest-only loans with extended interest-only periods, the Agencies note that since the average life of a mortgage is a function of the housing market and interest rates, the average may fluctuate over time. Additionally, the Agencies were concerned that excluding these loans from the underwriting standards could cause some creditors to change their market offerings to avoid application of the guidance. Accordingly, the final guidance does not exclude interest-only loans with extended interest-only periods.

Finally, regarding the assumption for the amount that the balance may increase due to negative amortization, the Agencies have revised the language to respond to commenters' requests for clarity. The basic standard, however, remains unchanged. The Agencies expect a borrower to demonstrate the capacity to repay the full loan amount that may be advanced.[4] This includes the initial loan amount plus any balance increase that may accrue from the negative amortization provision. The final document contains guidance on determining the amount of any balance increase that may accrue from the negative amortization provision, which does not necessarily equate to the full negative amortization cap for a particular loan.

The Agencies requested comment on whether the guidance should address consideration of future income or other future events in the qualification standards. The commenters generally agreed that there is no reliable method for considering future income or other future events in the underwriting process. Accordingly, the Agencies have not modified the guidance to address these issues.

Collateral-Dependent Loans

Commenters that specifically addressed this aspect of the guidance concurred that it is unsafe and unsound to rely solely on an individual borrower's ability to sell or refinance once amortization commences. However, many expressed concern about the possibility that the term ''collateral-dependent'', as it is used in the guidance, would be interpreted to apply to stated income and other reduced documentation loans.

To address this concern, the Agencies provided clarifying language in a footnote to this section. The final guidance provides that a loan will not be determined to be collateral-dependent solely because it was underwritten using reduced documentation.

Risk Layering

Financial institution and industry group commenters were generally critical of the risk layering provisions of the proposed guidance on the grounds that they were too prescriptive. These commenters argued that institutions should have flexibility in determining factors that mitigate additional risks presented by features such as reduced documentation and simultaneous second-lien loans. A number of commenters, however, including community and consumer organizations, financial institutions, and industry associations, suggested that reduced documentation loans should not be offered to subprime borrowers. Others questioned whether stated income loans are appropriate under any circumstances, when used with nontraditional mortgage products, or when used for wage earners who can readily provide standard documentation of their wages. Several commenters argued that simultaneous second-lien loans should be paired with nontraditional mortgage loans only when borrowers will continue to have substantial equity in the property.

The Agencies believe that the guidance provides adequate flexibility in the methods and approaches to mitigating risk, with respect to risk layering. While the Agencies have not prohibited any of the practices discussed, the guidance uniformly suggests strong quality control and risk mitigation factors with respect to these practices.

The Agencies declined to provide guidance recommending reduced documentation loans be limited to any particular set of circumstances. The final guidance recognizes that mitigating factors may determine whether such loans are appropriate but reminds institutions that a credible analysis of both a borrower's willingness and ability to repay is consistent with sound and prudent lending practices. The final guidance also cautions that institutions generally should be able to readily document income for wage earners through means such as W–2 statements, pay stubs, or tax returns.

Portfolio and Risk Management Practices

Many financial institution and industry group commenters opposed provisions of the proposed guidance for the setting of concentration limits. Some commenters advocated active monitoring of concentrations of diversification strategies as more

[4] This is similar to the standard in the Agencies' May 2005 *Credit Risk Management Guidance for Home Equity Lending* recommending that, for interest-only and variable rate HELOCs, borrowers should demonstrate the ability to amortize the fully drawn line over the loan term.

appropriate approaches. The intent of the guidance was not to set hard concentration limits for nontraditional mortgage products. Instead, institutions with concentrations in these products should have well-developed monitoring systems and risk management practices. The guidance was clarified to reiterate this point.

Additionally, a number of financial institution and industry association commenters opposed the provisions regarding third-party originations. They argued that the proposal would force lenders to have an awareness and control over third-party practices that is neither realistic nor practical. In particular, many of these commenters argued that lenders should not be responsible for overseeing the marketing and borrower disclosure practices of third parties.

Regarding controls over third-party practices, the Agencies clarified their expectations that institutions should have strong systems and controls for establishing and maintaining relationships with third parties. Reliance on third-party relationships can significantly increase an institution's risk profile. The guidance, therefore, emphasizes the need for institutions to exercise appropriate due diligence prior to entering into a third-party relationship and to provide ongoing, effective oversight and controls. In practice, an institution's risk management system should reflect the complexity of its third-party activities and the overall level of risk involved.

A number of commenters urged the Agencies to remove language in the proposed guidance relating to implicit recourse for loans sold in the secondary market. They expressed concern that the proposal added new capital requirements. The Agencies clarified the language in the guidance addressing this issue. The Agencies do not intend to establish new capital requirements. Instead, the Agencies' intent is to reiterate existing guidelines regarding implicit recourse under the Agencies' risk-based capital rules.

Consumer Protection Issues

Communications With Consumers

Many financial institution and trade group commenters suggested that the Agencies' consumer protection goals would be better accomplished through generally applicable regulations, such as Regulation Z (Truth in Lending) [5] or Regulation X (Real Estate Settlement Procedures).[6] Some commenters stated that the proposed guidance would add burdensome new disclosure requirements and cause a confusing overlap with current Regulation Z requirements. They also expressed concern that the guidance would contribute to an overload of information currently provided to consumers. Additionally, some argued that implementing the disclosure provisions might trigger Regulation Z requirements concerning advertising.[7] Some commenters also urged the Agencies to adopt model disclosure forms or other descriptive materials to assist in compliance with the guidance.

Some commenters voiced concern that the Agencies are attempting to establish a suitability standard similar to that used in the securities context. These commenters argued that lenders are not in a position to determine which products are most suitable for borrowers, and that this decision should be left to borrowers themselves.

Finally, several community and consumer organization commenters questioned whether additional disclosures are sufficient to protect borrowers and suggested various additional measures, such as consumer education and counseling.

The Agencies carefully considered the commenters' argument that consumer protection issues—particularly, disclosures—would be better addressed through generally applicable regulations. The Agencies determined, however, that given the growth in this market, guidelines are needed now to ensure that consumers will receive the information they need about the material features of nontraditional mortgages as soon as possible.

The Agencies also gave careful consideration to the commenters' concerns that the guidelines will overlap with Regulation Z, add to the disclosure burden on lenders, and contribute to information overload. While the Agencies are sensitive to these concerns, we do not believe they warrant significant changes to the guidance. The guidance focuses on providing information to consumers during the pre-application shopping phase and post-closing with any monthly statements lenders choose to provide to consumers. Moreover, the Agencies do not anticipate that the information outlined in the guidance will result in additional lengthy disclosures. Rather, the Agencies contemplate that the information can be provided in brief narrative format and through the use of examples based on hypothetical loan transactions.[8] We have, however, revised the guidance to make clear that transaction-specific disclosures are not required. Institutions will still need to ensure that their marketing materials promoting their products comply with Regulation Z, as applicable.

As previously discussed, some commenters, including industry trade associations, asked the Agencies to include model or sample disclosures or other descriptive materials as part of the guidance to assist lenders, including smaller institutions, in following the recommended practices for communications with consumers. The Agencies have determined not to include required model or sample disclosures in the guidance. Instead, the guidance provides a set of recommended practices to assist institutions in addressing particular risks raised by nontraditional mortgage products.

The Agencies have determined that it is desirable to first seek public comment on potential model disclosures, and in a **Federal Register** notice accompanying this guidance are seeking comment on proposed illustrations of consumer information for nontraditional mortgage products that are consistent with the recommendations contained in the guidance. The Agencies appreciate that some institutions, including community banks, following the recommendations set forth in the guidance may prefer not to incur the costs and other burdens of developing their own consumer information documents. The Agencies are, therefore, requesting comment on illustrations of the type of information contemplated by the guidance.

The Agencies disagree with the commenters who expressed concern that the guidance appears to establish a suitability standard, under which lenders would be required to assist borrowers in choosing products that are suitable to their needs and circumstances. It was not the Agencies' intent to impose such a standard, nor is there any language in the guidance that does so. In any event, the Agencies have revised certain statements in the proposed guidance that could have been interpreted to suggest a requirement to ensure that borrowers select products appropriate to their circumstances.

Control Systems

Several commenters requested more flexibility in designing appropriate control systems. The Agencies have

[5] 12 CFR part 226 (2006).

[6] 24 CFR part 3500 (2005).

[7] *See* 12 CFR part 226.24(c) (2006).

[8] *See* elsewhere in today's issue of the **Federal Register**. (Proposed Illustrations of Consumer Information for Nontraditional Mortgage Products).

revised the ''Control Systems'' portion of the guidance to clarify that we are not requiring any particular means of monitoring adherence to an institution's policies, such as call monitoring or mystery shopping. Additional changes have also been made to clarify that the Agencies do not expect institutions to assume an unwarranted level of responsibility for the actions of third parties. Rather, the control systems that are expected for loans purchased from or originated through third parties are consistent with the Agencies' current supervisory policies. As previously discussed, the Agencies have also made changes to the portfolio and risk management practices portion of the final guidance to clarify their expectations concerning oversight and monitoring of third-party originations.

IV. Text of Final Joint Guidance

The text of the final Interagency Guidance on Nontraditional Mortgage Product Risks follows:

Interagency Guidance on Nontraditional Mortgage Product Risks

Residential mortgage lending has traditionally been a conservatively managed business with low delinquencies and losses and reasonably stable underwriting standards. In the past few years consumer demand has been growing, particularly in high priced real estate markets, for closed-end residential mortgage loan products that allow borrowers to defer repayment of principal and, sometimes, interest. These mortgage products, herein referred to as nontraditional mortgage loans, include such products as ''interest-only'' mortgages where a borrower pays no loan principal for the first few years of the loan and ''payment option'' adjustable-rate mortgages (ARMs) where a borrower has flexible payment options with the potential for negative amortization.[1]

While some institutions have offered nontraditional mortgages for many years with appropriate risk management and sound portfolio performance, the market for these products and the number of institutions offering them has expanded rapidly. Nontraditional mortgage loan products are now offered by more lenders to a wider spectrum of borrowers who may not otherwise qualify for more traditional mortgage loans and may not fully understand the associated risks.

Many of these nontraditional mortgage loans are underwritten with less stringent income and asset verification requirements (''reduced documentation'') and are increasingly combined with simultaneous second-lien loans.[2] Such risk layering, combined with the broader marketing of nontraditional mortgage loans, exposes financial institutions to increased risk relative to traditional mortgage loans.

Given the potential for heightened risk levels, management should carefully consider and appropriately mitigate exposures created by these loans. To manage the risks associated with nontraditional mortgage loans, management should:

- Ensure that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower's repayment capacity;
- Recognize that many nontraditional mortgage loans, particularly when they have risk-layering features, are untested in a stressed environment. As evidenced by experienced institutions, these products warrant strong risk management standards, capital levels commensurate with the risk, and an allowance for loan and lease losses that reflects the collectibility of the portfolio; and
- Ensure that consumers have sufficient information to clearly understand loan terms and associated risks prior to making a product choice.

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS) and the National Credit Union Administration (NCUA) (collectively, the Agencies) expect institutions to effectively assess and manage the risks associated with nontraditional mortgage loan products.[3]

Institutions should use this guidance to ensure that risk management practices adequately address these risks. The Agencies will carefully scrutinize risk management processes, policies, and procedures in this area. Institutions that do not adequately manage these risks will be asked to take remedial action.

The focus of this guidance is on the higher risk elements of certain nontraditional mortgage products, not the product type itself. Institutions with sound underwriting, adequate risk management, and acceptable portfolio performance will not be subject to criticism merely for offering such products.

Loan Terms and Underwriting Standards

When an institution offers nontraditional mortgage loan products, underwriting standards should address the effect of a substantial payment increase on the borrower's capacity to repay when loan amortization begins. Underwriting standards should also comply with the agencies' real estate lending standards and appraisal regulations and associated guidelines.[4]

Central to prudent lending is the internal discipline to maintain sound loan terms and underwriting standards despite competitive pressures. Institutions are strongly cautioned against ceding underwriting standards to third parties that have different business objectives, risk tolerances, and core competencies. Loan terms should be based on a disciplined analysis of potential exposures and compensating factors to ensure risk levels remain manageable.

Qualifying Borrowers—Payments on nontraditional loans can increase significantly when the loans begin to amortize. Commonly referred to as payment shock, this increase is of particular concern for payment option ARMs where the borrower makes minimum payments that may result in negative amortization. Some institutions manage the potential for excessive negative amortization and payment shock by structuring the initial terms to limit the spread between the introductory interest rate and the fully indexed rate. Nevertheless, an institution's qualifying standards should recognize the potential impact of payment shock, especially for borrowers

[1] Interest-only and payment option ARMs are variations of conventional ARMs, hybrid ARMs, and fixed rate products. Refer to the Appendix for additional information on interest-only and payment option ARM loans. This guidance does not apply to reverse mortgages; home equity lines of credit (''HELOCs''), other than as discussed in the Simultaneous Second-Lien Loans section; or fully amortizing residential mortgage loan products.

[2] Refer to the Appendix for additional information on reduced documentation and simultaneous second-lien loans.

[3] Refer to Interagency Guidelines Establishing Standards for Safety and Soundness. For each Agency, those respective guidelines are addressed in: 12 CFR part 30 Appendix A (OCC); 12 CFR part 208 Appendix D–1 (Board); 12 CFR part 364 Appendix A (FDIC); 12 CFR part 570 Appendix A (OTS); and 12 U.S.C. 1786 (NCUA).

[4] Refer to 12 CFR part 34—Real Estate Lending and Appraisals, OCC Bulletin 2005–3—Standards for National Banks' Residential Mortgage Lending, AL 2003–7—Guidelines for Real Estate Lending Policies and AL 2003–9—Independent Appraisal and Evaluation Functions (OCC); 12 CFR 208.51 subpart E and Appendix C and 12 CFR part 225 subpart G (Board); 12 CFR part 365 and Appendix A, and 12 CFR part 323 (FDIC); 12 CFR 560.101 and Appendix and 12 CFR part 564 (OTS). Also, refer to the 1999 Interagency Guidance on the ''Treatment of High LTV Residential Real Estate Loans'' and the 1994 ''Interagency Appraisal and Evaluation Guidelines''. Federally Insured Credit Unions should refer to 12 CFR part 722—Appraisals and NCUA 03–CU–17—Appraisal and Evaluation Functions for Real Estate Related Transactions (NCUA).

with high loan-to-value (LTV) ratios, high debt-to-income (DTI) ratios, and low credit scores. Recognizing that an institution's underwriting criteria are based on multiple factors, an institution should consider these factors jointly in the qualification process and may develop a range of reasonable tolerances for each factor. However, the criteria should be based upon prudent and appropriate underwriting standards, considering both the borrower's characteristics and the product's attributes.

For all nontraditional mortgage loan products, an institution's analysis of a borrower's repayment capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed rate,[5] assuming a fully amortizing repayment schedule.[6] In addition, for products that permit negative amortization, the repayment analysis should be based upon the initial loan amount plus any balance increase that may accrue from the negative amortization provision.[7]

Furthermore, the analysis of repayment capacity should avoid over-reliance on credit scores as a substitute for income verification in the underwriting process. The higher a loan's credit risk, either from loan features or borrower characteristics, the more important it is to verify the borrower's income, assets, and outstanding liabilities.

Collateral-Dependent Loans—Institutions should avoid the use of loan terms and underwriting practices that may heighten the need for a borrower to rely on the sale or refinancing of the property once amortization begins. Loans to individuals who do not demonstrate the capacity to repay, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound.[8] Institutions that originate collateral-dependent mortgage loans may be subject to criticism, corrective action, and higher capital requirements.

Risk Layering—Institutions that originate or purchase mortgage loans that combine nontraditional features, such as interest only loans with reduced documentation or a simultaneous second-lien loan, face increased risk. When features are layered, an institution should demonstrate that mitigating factors support the underwriting decision and the borrower's repayment capacity. Mitigating factors could include higher credit scores, lower LTV and DTI ratios, significant liquid assets, mortgage insurance or other credit enhancements. While higher pricing is often used to address elevated risk levels, it does not replace the need for sound underwriting.

Reduced Documentation—Institutions increasingly rely on reduced documentation, particularly unverified income, to qualify borrowers for nontraditional mortgage loans. Because these practices essentially substitute assumptions and unverified information for analysis of a borrower's repayment capacity and general creditworthiness, they should be used with caution. As the level of credit risk increases, the Agencies expect an institution to more diligently verify and document a borrower's income and debt reduction capacity. Clear policies should govern the use of reduced documentation. For example, stated income should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity. For many borrowers, institutions generally should be able to readily document income using recent W–2 statements, pay stubs, or tax returns.

Simultaneous Second-Lien Loans—Simultaneous second-lien loans reduce owner equity and increase credit risk. Historically, as combined loan-to-value ratios rise, so do defaults. A delinquent borrower with minimal or no equity in a property may have little incentive to work with a lender to bring the loan current and avoid foreclosure. In addition, second-lien home equity lines of credit (HELOCs) typically increase borrower exposure to increasing interest rates and monthly payment burdens. Loans with minimal or no owner equity generally should not have a payment structure that allows for delayed or negative amortization without other significant risk mitigating factors.

Introductory Interest Rates—Many institutions offer introductory interest rates set well below the fully indexed rate as a marketing tool for payment option ARM products. When developing nontraditional mortgage product terms, an institution should consider the spread between the introductory rate and the fully indexed rate. Since initial and subsequent monthly payments are based on these low introductory rates, a wide initial spread means that borrowers are more likely to experience negative amortization, severe payment shock, and an earlier-than-scheduled recasting of monthly payments. Institutions should minimize the likelihood of disruptive early recastings and extraordinary payment shock when setting introductory rates.

Lending to Subprime Borrowers—Mortgage programs that target subprime borrowers through tailored marketing, underwriting standards, and risk selection should follow the applicable interagency guidance on subprime lending.[9] Among other things, the subprime guidance discusses circumstances under which subprime lending can become predatory or abusive. Institutions designing nontraditional mortgage loans for subprime borrowers should pay particular attention to this guidance. They should also recognize that risk-layering features in loans to subprime borrowers may significantly increase risks for both the institution and the borrower.

Non-Owner-Occupied Investor Loans—Borrowers financing non-owner-occupied investment properties should qualify for loans based on their ability to service the debt over the life of the

[5] The fully indexed rate equals the index rate prevailing at origination plus the margin that will apply after the expiration of an introductory interest rate. The index rate is a published interest rate to which the interest rate on an ARM is tied. Some commonly used indices include the 1-Year Constant Maturity Treasury Rate (CMT), the 6-Month London Interbank Offered Rate (LIBOR), the 11th District Cost of Funds (COFI), and the Moving Treasury Average (MTA), a 12-month moving average of the monthly average yields of U.S. Treasury securities adjusted to a constant maturity of one year. The margin is the number of percentage points a lender adds to the index value to calculate the ARM interest rate at each adjustment period. In different interest rate scenarios, the fully indexed rate for an ARM loan based on a lagging index (e.g., MTA rate) may be significantly different from the rate on a comparable 30-year fixed-rate product. In these cases, a credible market rate should be used to qualify the borrower and determine repayment capacity.

[6] The fully amortizing payment schedule should be based on the term of the loan. For example, the amortizing payment for a loan with a 5-year interest only period and a 30-year term would be calculated based on a 30-year amortization schedule. For balloon mortgages that contain a borrower option for an extended amortization period, the fully amortizing payment schedule can be based on the full term the borrower may choose.

[7] The balance that may accrue from the negative amortization provision does not necessarily equate to the full negative amortization cap for a particular loan. The spread between the introductory or ''teaser'' rate and the accrual rate will determine whether or not a loan balance has the potential to reach the negative amortization cap before the end of the initial payment option period (usually five years). For example, a loan with a 115 percent negative amortization cap but a small spread between the introductory rate and the accrual rate may only reach a 109 percent maximum loan balance before the end of the initial payment option period, even if only minimum payments are made. The borrower could be qualified based on this lower maximum loan balance.

[8] A loan will not be determined to be ''collateral-dependent'' solely through the use of reduced documentation.

[9] Interagency Guidance on Subprime Lending, March 1, 1999, and Expanded Guidance for Subprime Lending Programs, January 31, 2001. Federally insured credit unions should refer to 04–CU–12—Specialized Lending Activities (NCUA).

loan. Loan terms should reflect an appropriate combined LTV ratio that considers the potential for negative amortization and maintains sufficient borrower equity over the life of the loan. Further, underwriting standards should require evidence that the borrower has sufficient cash reserves to service the loan, considering the possibility of extended periods of property vacancy and the variability of debt service requirements associated with nontraditional mortgage loan products.[10]

Portfolio and Risk Management Practices

Institutions should ensure that risk management practices keep pace with the growth and changing risk profile of their nontraditional mortgage loan portfolios and changes in the market. Active portfolio management is especially important for institutions that project or have already experienced significant growth or concentration levels. Institutions that originate or invest in nontraditional mortgage loans should adopt more robust risk management practices and manage these exposures in a thoughtful, systematic manner. To meet these expectations, institutions should:

- Develop written policies that specify acceptable product attributes, production and portfolio limits, sales and securitization practices, and risk management expectations;
- Design enhanced performance measures and management reporting that provide early warning for increasing risk;
- Establish appropriate ALLL levels that consider the credit quality of the portfolio and conditions that affect collectibility; and
- Maintain capital at levels that reflect portfolio characteristics and the effect of stressed economic conditions on collectibility. Institutions should hold capital commensurate with the risk characteristics of their nontraditional mortgage loan portfolios.

Policies—An institution's policies for nontraditional mortgage lending activity should set acceptable levels of risk through its operating practices, accounting procedures, and policy exception tolerances. Policies should reflect appropriate limits on risk layering and should include risk management tools for risk mitigation purposes. Further, an institution should set growth and volume limits by loan type, with special attention for products and product combinations in need of heightened attention due to easing terms or rapid growth.

Concentrations—Institutions with concentrations in nontraditional mortgage products should have well-developed monitoring systems and risk management practices. Monitoring should keep track of concentrations in key portfolio segments such as loan types, third-party originations, geographic area, and property occupancy status. Concentrations also should be monitored by key portfolio characteristics such as loans with high combined LTV ratios, loans with high DTI ratios, loans with the potential for negative amortization, loans to borrowers with credit scores below established thresholds, loans with risk-layered features, and non-owner-occupied investor loans. Further, institutions should consider the effect of employee incentive programs that could produce higher concentrations of nontraditional mortgage loans. Concentrations that are not effectively managed will be subject to elevated supervisory attention and potential examiner criticism to ensure timely remedial action.

Controls—An institution's quality control, compliance, and audit procedures should focus on mortgage lending activities posing high risk. Controls to monitor compliance with underwriting standards and exceptions to those standards are especially important for nontraditional loan products. The quality control function should regularly review a sample of nontraditional mortgage loans from all origination channels and a representative sample of underwriters to confirm that policies are being followed. When control systems or operating practices are found deficient, business-line managers should be held accountable for correcting deficiencies in a timely manner. Since many nontraditional mortgage loans permit a borrower to defer principal and, in some cases, interest payments for extended periods, institutions should have strong controls over accruals, customer service and collections. Policy exceptions made by servicing and collections personnel should be carefully monitored to confirm that practices such as re-aging, payment deferrals, and loan modifications are not inadvertently increasing risk. Customer service and collections personnel should receive product-specific training on the features and potential customer issues with these products.

Third-Party Originations—Institutions often use third parties, such as mortgage brokers or correspondents, to originate nontraditional mortgage loans. Institutions should have strong systems and controls in place for establishing and maintaining relationships with third parties, including procedures for performing due diligence. Oversight of third parties should involve monitoring the quality of originations so that they reflect the institution's lending standards and compliance with applicable laws and regulations.

Monitoring procedures should track the quality of loans by both origination source and key borrower characteristics. This will help institutions identify problems such as early payment defaults, incomplete documentation, and fraud. If appraisal, loan documentation, credit problems or consumer complaints are discovered, the institution should take immediate action. Remedial action could include more thorough application reviews, more frequent re-underwriting, or even termination of the third-party relationship.[11]

Secondary Market Activity—The sophistication of an institution's secondary market risk management practices should be commensurate with the nature and volume of activity. Institutions with significant secondary market activities should have comprehensive, formal strategies for managing risks.[12] Contingency planning should include how the institution will respond to reduced demand in the secondary market.

While third-party loan sales can transfer a portion of the credit risk, an institution remains exposed to reputation risk when credit losses on sold mortgage loans or securitization transactions exceed expectations. As a result, an institution may determine that it is necessary to repurchase defaulted mortgages to protect its reputation and maintain access to the markets. In the agencies' view, the repurchase of mortgage loans beyond the selling institution's contractual obligation is

[10] Federally insured credit unions must comply with 12 CFR part 723 for loans meeting the definition of member business loans.

[11] Refer to OCC Bulletin 2001–47—Third-Party Relationships and AL 2000–9—Third-Party Risk (OCC). Federally insured credit unions should refer to 01–CU–20 (NCUA), Due Diligence over Third Party Service Providers. Savings associations should refer to OTS Thrift Bulletin 82a—Third Party Arrangements.

[12] Refer to ''Interagency Questions and Answers on Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations'', May 23, 2002; OCC Bulletin 2002–22 (OCC); SR letter 02–16 (Board); Financial Institution Letter (FIL–54–2002) (FDIC); and CEO Letter 163 (OTS). *See* OCC's Comptroller Handbook for Asset Securitization, November 1997. *See* OTS Examination Handbook Section 221, Asset-Backed Securitization. The Board also addressed risk management and capital adequacy of exposures arising from secondary market credit activities in SR letter 97–21. Federally insured credit unions should refer to 12 CFR Part 702 (NCUA).

implicit recourse. Under the agencies' risk-based capital rules, a repurchasing institution would be required to maintain risk-based capital against the entire pool or securitization.[13] Institutions should familiarize themselves with these guidelines before deciding to support mortgage loan pools or buying back loans in default.

Management Information and Reporting—Reporting systems should allow management to detect changes in the risk profile of its nontraditional mortgage loan portfolio. The structure and content should allow the isolation of key loan products, risk-layering loan features, and borrower characteristics. Reporting should also allow management to recognize deteriorating performance in any of these areas before it has progressed too far. At a minimum, information should be available by loan type (*e.g.*, interest-only mortgage loans and payment option ARMs); by risk-layering features (*e.g.*, payment option ARM with stated income and interest-only mortgage loans with simultaneous second-lien mortgages); by underwriting characteristics (*e.g.*, LTV, DTI, and credit score); and by borrower performance (*e.g.*, payment patterns, delinquencies, interest accruals, and negative amortization).

Portfolio volume and performance should be tracked against expectations, internal lending standards and policy limits. Volume and performance expectations should be established at the subportfolio and aggregate portfolio levels. Variance analyses should be performed regularly to identify exceptions to policies and prescribed thresholds. Qualitative analysis should occur when actual performance deviates from established policies and thresholds. Variance analysis is critical to the monitoring of a portfolio's risk characteristics and should be an integral part of establishing and adjusting risk tolerance levels.

Stress Testing—Based on the size and complexity of their lending operations, institutions should perform sensitivity analysis on key portfolio segments to identify and quantify events that may increase risks in a segment or the entire portfolio. The scope of the analysis should generally include stress tests on key performance drivers such as interest rates, employment levels, economic growth, housing value fluctuations, and other factors beyond the institution's immediate control. Stress tests typically assume rapid deterioration in one or more factors and attempt to estimate the potential influence on default rates and loss severity. Stress testing should aid an institution in identifying, monitoring and managing risk, as well as developing appropriate and cost-effective loss mitigation strategies. The stress testing results should provide direct feedback in determining underwriting standards, product terms, portfolio concentration limits, and capital levels.

Capital and Allowance for Loan and Lease Losses—Institutions should establish an appropriate allowance for loan and lease losses (ALLL) for the estimated credit losses inherent in their nontraditional mortgage loan portfolios. They should also consider the higher risk of loss posed by layered risks when establishing their ALLL.

Moreover, institutions should recognize that their limited performance history with these products, particularly in a stressed environment, increases performance uncertainty. Capital levels should be commensurate with the risk characteristics of the nontraditional mortgage loan portfolios. Lax underwriting standards or poor portfolio performance may warrant higher capital levels.

When establishing an appropriate ALLL and considering the adequacy of capital, institutions should segment their nontraditional mortgage loan portfolios into pools with similar credit risk characteristics. The basic segments typically include collateral and loan characteristics, geographic concentrations, and borrower qualifying attributes. Segments could also differentiate loans by payment and portfolio characteristics, such as loans on which borrowers usually make only minimum payments, mortgages with existing balances above original balances, and mortgages subject to sizable payment shock. The objective is to identify credit quality indicators that affect collectibility for ALLL measurement purposes. In addition, understanding characteristics that influence expected performance also provides meaningful information about future loss exposure that would aid in determining adequate capital levels.

Institutions with material mortgage banking activities and mortgage servicing assets should apply sound practices in valuing the mortgage servicing rights for nontraditional mortgages. In accordance with interagency guidance, the valuation process should follow generally accepted accounting principles and use reasonable and supportable assumptions.[14]

Consumer Protection Issues

While nontraditional mortgage loans provide flexibility for consumers, the Agencies are concerned that consumers may enter into these transactions without fully understanding the product terms. Nontraditional mortgage products have been advertised and promoted based on their affordability in the near term; that is, their lower initial monthly payments compared with traditional types of mortgages. In addition to apprising consumers of the benefits of nontraditional mortgage products, institutions should take appropriate steps to alert consumers to the risks of these products, including the likelihood of increased future payment obligations. This information should be provided in a timely manner—before disclosures may be required under the Truth in Lending Act or other laws—to assist the consumer in the product selection process.

Concerns and Objectives—More than traditional ARMs, mortgage products such as payment option ARMs and interest-only mortgages can carry a significant risk of payment shock and negative amortization that may not be fully understood by consumers. For example, consumer payment obligations may increase substantially at the end of an interest-only period or upon the "recast" of a payment option ARM. The magnitude of these payment increases may be affected by factors such as the expiration of promotional interest rates, increases in the interest rate index, and negative amortization. Negative amortization also results in lower levels of home equity as compared to a traditional amortizing mortgage product. When borrowers go to sell or refinance the property, they may find that negative amortization has substantially reduced or eliminated their equity in it even when the property has appreciated. The concern that consumers may not fully understand these products would be exacerbated by marketing and promotional practices that emphasize potential benefits without also providing clear and balanced information about material risks.

In light of these considerations, communications with consumers,

[13] Refer to 12 CFR part 3 Appendix A, Section 4 (OCC); 12 CFR parts 208 and 225, Appendix A, III.B.3 (FRB); 12 CFR part 325, Appendix A, II.B (FDIC); 12 CFR 567 (OTS); and 12 CFR part 702 (NCUA) for each Agency's capital treatment of recourse.

[14] Refer to the "Interagency Advisory on Mortgage Banking", February 25, 2003, issued by the bank and thrift regulatory agencies. Federally Insured Credit Unions with assets of $10 million or more are reminded they must report and value nontraditional mortgages and related mortgage servicing rights, if any, consistent with generally accepted accounting principles in the Call Reports they file with the NCUA Board.

including advertisements, oral statements, promotional materials, and monthly statements, should provide clear and balanced information about the relative benefits and risks of these products, including the risk of payment shock and the risk of negative amortization. Clear, balanced, and timely communication to consumers of the risks of these products will provide consumers with useful information at crucial decision-making points, such as when they are shopping for loans or deciding which monthly payment amount to make. Such communication should help minimize potential consumer confusion and complaints, foster good customer relations, and reduce legal and other risks to the institution.

Legal Risks—Institutions that offer nontraditional mortgage products must ensure that they do so in a manner that complies with all applicable laws and regulations. With respect to the disclosures and other information provided to consumers, applicable laws and regulations include the following:

- Truth in Lending Act (TILA) and its implementing regulation, Regulation Z.
- Section 5 of the Federal Trade Commission Act (FTC Act). TILA and Regulation Z contain rules governing disclosures that institutions must provide for closed-end mortgages in advertisements, with an application,[15] before loan consummation, and when interest rates change. Section 5 of the FTC Act prohibits unfair or deceptive acts or practices.[16]

Other Federal laws, including the fair lending laws and the Real Estate Settlement Procedures Act (RESPA), also apply to these transactions. Moreover, the Agencies note that the sale or securitization of a loan may not affect an institution's potential liability for violations of TILA, RESPA, the FTC Act, or other laws in connection with its origination of the loan. State laws, including laws regarding unfair or deceptive acts or practices, also may apply.

Recommended Practices

Recommended practices for addressing the risks raised by nontraditional mortgage products include the following:[17]

Communications with Consumers—When promoting or describing nontraditional mortgage products, institutions should provide consumers with information that is designed to help them make informed decisions when selecting and using these products. Meeting this objective requires appropriate attention to the timing, content, and clarity of information presented to consumers. Thus, institutions should provide consumers with information at a time that will help consumers select products and choose among payment options. For example, institutions should offer clear and balanced product descriptions when a consumer is shopping for a mortgage—such as when the consumer makes an inquiry to the institution about a mortgage product and receives information about nontraditional mortgage products, or when marketing relating to nontraditional mortgage products is provided by the institution to the consumer—not just upon the submission of an application or at consummation.[18] The provision of such information would serve as an important supplement to the disclosures currently required under TILA and Regulation Z or other laws.[19]

Promotional Materials and Product Descriptions. Promotional materials and other product descriptions should provide information about the costs, terms, features, and risks of nontraditional mortgages that can assist consumers in their product selection decisions, including information about the matters discussed below.

- *Payment Shock.* Institutions should apprise consumers of potential increases in payment obligations for these products, including circumstances in which interest rates or negative amortization reach a contractual limit. For example, product descriptions could state the maximum monthly payment a consumer would be required to pay under a hypothetical loan example once amortizing payments are required and the interest rate and negative amortization caps have been reached.[20] Such information also could describe when structural payment changes will occur (*e.g.*, when introductory rates expire, or when amortizing payments are required), and what the new payment amount would be or how it would be calculated. As applicable, these descriptions could indicate that a higher payment may be required at other points in time due to factors such as negative amortization or increases in the interest rate index.
- *Negative Amortization.* When negative amortization is possible under the terms of a nontraditional mortgage product, consumers should be apprised of the potential for increasing principal balances and decreasing home equity, as well as other potential adverse consequences of negative amortization. For example, product descriptions should disclose the effect of negative amortization on loan balances and home equity, and could describe the potential consequences to the consumer of making minimum payments that cause the loan to negatively amortize. (One possible consequence is that it could be more difficult to refinance the loan or to obtain cash upon a sale of the home).
- *Prepayment Penalties.* If the institution may impose a penalty in the event that the consumer prepays the mortgage, consumers should be alerted to this fact and to the need to ask the lender about the amount of any such penalty.[21]
- *Cost of Reduced Documentation Loans.* If an institution offers both reduced and full documentation loan programs and there is a pricing premium attached to the reduced documentation program, consumers should be alerted to this fact.

[15] These program disclosures apply to ARM products and must be provided at the time an application is provided or before the consumer pays a nonrefundable fee, whichever is earlier.

[16] The OCC, the Board, and the FDIC enforce this provision under the FTC Act and section 8 of the FDI Act. Each of these agencies has also issued supervisory guidance to the institutions under their respective jurisdictions concerning unfair or deceptive acts or practices. *See* OCC Advisory Letter 2002–3—Guidance on Unfair or Deceptive Acts or Practices, March 22, 2002; Joint Board and FDIC Guidance on Unfair or Deceptive Acts or Practices by State-Chartered Banks, March 11, 2004. Federally insured credit unions are prohibited from using any advertising or promotional material that is inaccurate, misleading, or deceptive in any way concerning its products, services, or financial condition. 12 CFR 740.2. The OTS also has a regulation that prohibits savings associations from using advertisements or other representations that are inaccurate or misrepresent the services or contracts offered. 12 CFR 563.27. This regulation supplements its authority under the FTC Act.

[17] Institutions also should review the recommendations relating to mortgage lending practices set forth in other supervisory guidance from their respective primary regulators, as applicable, including guidance on abusive lending practices.

[18] Institutions also should strive to: (1) Focus on information important to consumer decision making; (2) highlight key information so that it will be noticed; (3) employ a user-friendly and readily navigable format for presenting the information; and (4) use plain language, with concrete and realistic examples. Comparative tables and information describing key features of available loan products, including reduced documentation programs, also may be useful for consumers considering the nontraditional mortgage products and other loan features described in this guidance.

[19] Institutions may not be able to incorporate all of the practices recommended in this guidance when advertising nontraditional mortgages through certain forms of media, such as radio, television, or billboards. Nevertheless, institutions should provide clear and balanced information about the risks of these products in all forms of advertising.

[20] Consumers also should be apprised of other material changes in payment obligations, such as balloon payments.

[21] Federal credit unions are prohibited from imposing prepayment penalties. 12 CFR 701.21(c)(6).

Monthly Statements on Payment Option ARMs. Monthly statements that are provided to consumers on payment option ARMs should provide information that enables consumers to make informed payment choices, including an explanation of each payment option available and the impact of that choice on loan balances. For example, the monthly payment statement should contain an explanation, as applicable, next to the minimum payment amount that making this payment would result in an increase to the consumer's outstanding loan balance. Payment statements also could provide the consumer's current loan balance, what portion of the consumer's previous payment was allocated to principal and to interest, and, if applicable, the amount by which the principal balance increased. Institutions should avoid leading payment option ARM borrowers to select a non-amortizing or negatively-amortizing payment (for example, through the format or content of monthly statements).

Practices to Avoid. Institutions also should avoid practices that obscure significant risks to the consumer. For example, if an institution advertises or promotes a nontraditional mortgage by emphasizing the comparatively lower initial payments permitted for these loans, the institution also should provide clear and comparably prominent information alerting the consumer to the risks. Such information should explain, as relevant, that these payment amounts will increase, that a balloon payment may be due, and that the loan balance will not decrease and may even increase due to the deferral of interest and/or principal payments. Similarly, institutions should avoid promoting payment patterns that are structurally unlikely to occur.[22] Such practices could raise legal and other risks for institutions, as described more fully above.

Institutions also should avoid such practices as: Giving consumers unwarranted assurances or predictions about the future direction of interest rates (and, consequently, the borrower's future obligations); making one-sided representations about the cash savings or expanded buying power to be realized from nontraditional mortgage products in comparison with amortizing mortgages; suggesting that initial minimum payments in a payment option ARM will cover accrued interest (or principal and interest) charges; and making misleading claims that interest rates or payment obligations for these products are ''fixed''.

Control Systems—Institutions should develop and use strong control systems to monitor whether actual practices are consistent with their policies and procedures relating to nontraditional mortgage products. Institutions should design control systems to address compliance and consumer information concerns as well as the safety and soundness considerations discussed in this guidance. Lending personnel should be trained so that they are able to convey information to consumers about product terms and risks in a timely, accurate, and balanced manner. As products evolve and new products are introduced, lending personnel should receive additional training, as necessary, to continue to be able to convey information to consumers in this manner. Lending personnel should be monitored to determine whether they are following these policies and procedures. Institutions should review consumer complaints to identify potential compliance, reputation, and other risks. Attention should be paid to appropriate legal review and to using compensation programs that do not improperly encourage lending personnel to direct consumers to particular products.

With respect to nontraditional mortgage loans that an institution makes, purchases, or services using a third party, such as a mortgage broker, correspondent, or other intermediary, the institution should take appropriate steps to mitigate risks relating to compliance and consumer information concerns discussed in this guidance. These steps would ordinarily include, among other things, (1) Conducting due diligence and establishing other criteria for entering into and maintaining relationships with such third parties, (2) establishing criteria for third-party compensation designed to avoid providing incentives for originations inconsistent with this guidance, (3) setting requirements for agreements with such third parties, (4) establishing procedures and systems to monitor compliance with applicable agreements, bank policies, and laws, and (5) implementing appropriate corrective actions in the event that the third party fails to comply with applicable agreements, bank policies, or laws.

[22] For example, marketing materials for payment option ARMs may promote low predictable payments until the recast date. Such marketing should be avoided in circumstances in which the minimum payments are so low that negative amortization caps would be reached and higher payment obligations would be triggered before the scheduled recast, even if interest rates remain constant.

Appendix: Terms Used in This Document

Interest-only Mortgage Loan—A nontraditional mortgage on which, for a specified number of years (*e.g.*, three or five years), the borrower is required to pay only the interest due on the loan during which time the rate may fluctuate or may be fixed. After the interest-only period, the rate may be fixed or fluctuate based on the prescribed index and payments include both principal and interest.

Payment Option ARM—A nontraditional mortgage that allows the borrower to choose from a number of different payment options. For example, each month, the borrower may choose a minimum payment option based on a ''start'' or introductory interest rate, an interest-only payment option based on the fully indexed interest rate, or a fully amortizing principal and interest payment option based on a 15-year or 30-year loan term, plus any required escrow payments. The minimum payment option can be less than the interest accruing on the loan, resulting in negative amortization. The interest-only option avoids negative amortization but does not provide for principal amortization. After a specified number of years, or if the loan reaches a certain negative amortization cap, the required monthly payment amount is recast to require payments that will fully amortize the outstanding balance over the remaining loan term.

Reduced Documentation—A loan feature that is commonly referred to as ''low doc/no doc'', ''no income/no asset'', ''stated income'' or ''stated assets''. For mortgage loans with this feature, an institution sets reduced or minimal documentation standards to substantiate the borrower's income and assets.

Simultaneous Second-Lien Loan—A lending arrangement where either a closed-end second-lien or a home equity line of credit (HELOC) is originated simultaneously with the first lien mortgage loan, typically in lieu of a higher down payment.

Dated: September 25, 2006.

John C. Dugan,

Comptroller of the Currency.

By order of the Board of Governors of the Federal Reserve System, September 27, 2006.

Jennifer J. Johnson,

Secretary of the Board.

Dated at Washington, DC, this 27th day of September, 2006.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary.

Dated: September 28, 2006.

By the Office of Thrift Supervision.

John M. Reich,

Director.

By the National Credit Union Administration on September 28, 2006.

JoAnn M. Johnson,

Chairman.

[FR Doc. 06–8480 Filed 10–3–06; 8:45 am]

BILLING CODE 4810–33–P, 6210–01–P, 6714–01–P, 6720–01–P, 7535–01–P

as fixed guideway miles for purposes of FTA's funding formulas.

Issued on January 8, 2007.

James S. Simpson,

Administrator.

[FR Doc. E7–263 Filed 1–10–07; 8:45 am]

BILLING CODE 4910–57–P

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

[Docket No. 06–17]

Office of Thrift Supervision

[Docket No. 2006–55]

FEDERAL RESERVE SYSTEM

[Docket No. OP–1254]

FEDERAL DEPOSIT INSURANCE CORPORATION

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–55043; File No. S7–08–06]

Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities

AGENCIES: Office of the Comptroller of the Currency, Treasury (''OCC''); Office of Thrift Supervision, Treasury (''OTS''); Board of Governors of the Federal Reserve System (''Board''); Federal Deposit Insurance Corporation (''FDIC''); and Securities and Exchange Commission (''SEC'') (collectively, the ''Agencies'').

ACTION: Notice of final interagency statement.

SUMMARY: The Agencies are adopting an Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities (''Final Statement''). The Final Statement pertains to national banks, state banks, bank holding companies (other than foreign banks), federal and state savings associations, savings and loan holding companies, U.S. branches and agencies of foreign banks, and SEC-registered broker-dealers and investment advisers (collectively, ''financial institutions'' or ''institutions'') engaged in complex structured finance transactions (''CSFTs''). In May 2004, the Agencies issued and requested comment on a proposed interagency statement (''Initial Proposed Statement''). After reviewing the comments received on the Initial Proposed Statement, the Agencies in May 2006 issued and requested comment on a revised proposed interagency statement (''Revised Proposed Statement''). The modifications to the Revised Proposed Statement, among other things, made the statement more principles-based and focused on the identification, review and approval process for those CSFTs that may pose heightened levels of legal or reputational risk to the relevant institution (referred to as ''elevated risk CSFTs''). After carefully reviewing the comments on the Revised Proposed Statement, the Agencies have adopted the Final Statement with minor modifications designed to clarify, but not alter, the principles set forth in the Revised Proposed Statement. The Final Statement describes some of the internal controls and risk management procedures that may help financial institutions identify, manage, and address the heightened reputational and legal risks that may arise from elevated risk CSFTs. As discussed further below, the Final Statement will not affect or apply to the vast majority of financial institutions, including most small institutions, nor does it create any private rights of action.

EFFECTIVE DATE: The Final Statement is effective January 11, 2007.

FOR FURTHER INFORMATION CONTACT:

OCC: Kathryn E. Dick, Deputy Comptroller, Credit and Market Risk, (202) 874–4660; Grace E. Dailey, Deputy Comptroller, Large Bank Supervision, (202) 874–4610; or Ellen Broadman, Director, Securities and Corporate Practices Division, (202) 874–5210, Office of the Comptroller of the Currency, 250 E Street, SW., Washington, DC 20219.

OTS: Fred J. Phillips-Patrick, Director, Credit Policy, (202) 906–7295, and Deborah S. Merkle, Project Manager, Credit Policy, (202) 906–5688, Examinations and Supervision Policy; or David A. Permut, Senior Attorney, Business Transactions Division, (202) 906–7505, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

Board: Sabeth I. Siddique, Assistant Director, (202) 452–3861, or Virginia Gibbs, Senior Supervisory Financial Analyst, (202) 452–2521, Division of Banking Supervision and Regulation; or Kieran J. Fallon, Assistant General Counsel, (202) 452–5270, or Anne B. Zorc, Senior Attorney, (202) 452–3876, Legal Division, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551. Users of Telecommunication Device for Deaf (TTD) only, call (202) 263–4869.

FDIC: Jason C. Cave, Associate Director, (202) 898–3548; Division of Supervision and Consumer Protection; or Mark G. Flanigan, Counsel, Supervision and Legislation Branch, Legal Division, (202) 898–7426, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

SEC: Mary Ann Gadziala, Associate Director, Office of Compliance Inspections and Examinations, (202) 551–6207; Catherine McGuire, Chief Counsel, Linda Stamp Sundberg, Senior Special Counsel (Banking and Derivatives), or Randall W. Roy, Branch Chief, Division of Market Regulation, (202) 551–5550, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549.

SUPPLEMENTARY INFORMATION:

I. Background

Financial markets have grown rapidly over the past decade, and innovations in financial instruments have facilitated the structuring of cash flows and allocation of risk among creditors, borrowers, and investors in more efficient ways. Financial derivatives for market and credit risk, asset-backed securities with customized cash flow features, specialized financial conduits that manage pools of assets, and other types of structured finance transactions serve important purposes, such as diversifying risk, allocating cash flows and reducing cost of capital. As a result, structured finance transactions, including the more complex variations of these transactions, now are an essential part of U.S. and international capital markets.

When a financial institution participates in a CSFT, it bears the usual market, credit, and operational risks associated with the transaction. In some circumstances, a financial institution also may face heightened legal or reputational risks due to its involvement in a CSFT. For example, a financial institution involved in a CSFT may face heightened legal or reputational risk if the customer's regulatory, tax or accounting treatment for the CSFT, or disclosures concerning the CSFT in its public filings or financial statements, do not comply with applicable laws, regulations or accounting principles.[1]

In some cases, certain CSFTs appear to have been used in illegal schemes

[1] For a memorandum on the potential liability of a financial institution for securities laws violations arising from participation in a CSFT, see Letter from Annette L. Nazareth, Director, Division of Market Regulation, Securities and Exchange Commission, to Richard Spillenkothen and Douglas W. Roeder, dated December 4, 2003 (available at *http://www.federalreserve.gov/boarddocs/srletters/2004/* and *http://www.occ.treas.gov).*

that misrepresented the financial condition of public companies to investors and regulatory authorities. After conducting investigations, the OCC, Federal Reserve System and SEC took strong and coordinated civil and administrative enforcement actions against certain financial institutions that engaged in CSFTs that appeared to have been designed or used to shield their customers' true financial health from the public. These actions involved the assessment of significant financial penalties on the institutions and required the institutions to take several measures to strengthen their risk management procedures for CSFTs.[2] The complex structured finance relationships involving these financial institutions also sparked an investigation by the Permanent Subcommittee on Governmental Affairs of the United States Senate,[3] as well as numerous lawsuits by private litigants.

The OCC, Federal Reserve System and SEC also conducted special reviews of several large financial institutions engaged in CSFTs, and the Agencies have focused attention on the CSFT activities of financial institutions in the normal course of the supervisory process. These reviews and activities indicate that many of the large financial institutions engaged in CSFTs have taken meaningful steps in recent years to improve their control infrastructure relating to CSFTs.

II. Initial and Revised Proposed Statements

To assist financial institutions in identifying, managing, and addressing the risks that may be associated with CSFTs, the Agencies developed and requested public comment on the Initial Proposed Statement.[4] The Initial Proposed Statement described the types of policies and procedures that a financial institution engaged in CSFTs should have in place to allow the institution to identify, document, evaluate, and control the full range of credit, market, operational, legal, and reputational risks that may arise from CSFTs. The agencies collectively received comments from more than 40 commenters on the Initial Proposed Statement. Although commenters generally supported the Agencies' efforts to describe the types of risk management procedures and internal controls that may help institutions manage the risks associated with CSFTs, virtually all of the commenters recommended changes to the Initial Proposed Statement.

After carefully reviewing the comments on the Initial Proposed Statement, the Agencies issued and requested comment on a Revised Proposed Statement.[5] The Revised Proposed Statement was modified in numerous respects to clarify the purpose, scope and effect of the statement; make the statement more risk-focused and principles based; and focus the statement on those CSFTs that may pose elevated levels of legal or reputational risk to the relevant institution.[6]

III. Overview of Comments on the Revised Proposed Statement

The Agencies collectively received written comments from 19 commenters on the Revised Proposed Statement, although many commenters submitted identical comments to multiple Agencies. Commenters included banking organizations, financial services trade associations, and individuals. Commenters generally expressed strong support for the Revised Proposed Statement, including its principles-based structure and focus on elevated risk CSFTs. Many commenters also asserted that the Revised Proposed Statement provides a financial institution appropriate flexibility to develop internal controls and risk management procedures that are tailored to the institution's own business activities and organizational structure.

Several commenters requested that the Agencies clarify or revise the Revised Proposed Statement in certain respects. For example, some commenters asked the Agencies to further streamline the provisions in the statement pertaining to documentation of elevated risk CSFTs, or clarify how the U.S. branches or agencies of foreign banks might implement risk management systems, policies or controls consistent with the statement's principles. In addition, some commenters asked the Agencies to set forth or clarify the legal standards governing the potential liability of financial institutions for CSFTs or provide ''safe harbors'' from such potential liability. One group of commenters also argued that the Revised Proposed Statement should not be implemented because it allegedly would encourage or condone illegal conduct by financial institutions. The comments received on the Revised Proposed Statement are further discussed below.

IV. Overview of Final Statement

After carefully reviewing the comments on the Revised Proposed Statement, the Agencies have made minor modifications to the Revised Proposed Statement in response to comments and to clarify the principles, scope, and intent of the Final Statement. The Final Statement has been adopted as supervisory guidance by the Board, OCC, FDIC and OTS and as a policy statement by the SEC. The Agencies will use the Final Statement going forward in reviewing the internal controls and risk management policies, procedures and systems of financial institutions engaged in CSFTs as part of the Agencies' ongoing supervisory process.

The Agencies continue to believe that it is important for a financial institution engaged in CSFTs to have policies and procedures that are designed to allow the institution to effectively manage and address the full range of risks associated with its CSFT activities, including the elevated legal or reputational risks that may arise in connection with certain CSFTs. For this reason, the Final Statement describes the types of risk management principles that the Agencies believe may help a financial institution to identify elevated risk CSFTs and to evaluate, manage, and address these risks within the institution's internal control framework.[7] These policies and procedures should, among other things, be designed to allow the institution to identify elevated risk CSFTs during its

[2] *See, e.g., In the Matter of Citigroup, Inc.,* Securities Exchange Act Release No. 48230 (July 28, 2003), Written Agreement by and between Citibank, N.A. and the Office of the Comptroller of the Currency, No. 2003–77 (July 28, 2003) (pertaining to transactions entered into by Citibank, N.A. with Enron Corp.) and Written Agreement by and between Citigroup, Inc. and the Federal Reserve Bank of New York, dated July 28, 2003 (pertaining to transactions involving Citigroup Inc. and its subsidiaries and Enron Corp. and Dynegy Inc.); *SEC* v. *J.P. Morgan Chase,* SEC Litigation Release No. 18252 (July 28, 2003) and Written Agreement by and among J.P. Morgan Chase & Co., the Federal Reserve Bank of New York, and the New York State Banking Department, dated July 28, 2003 (pertaining to transactions involving J.P. Morgan Chase & Co. and its subsidiaries and Enron Corp.).

[3] *See Fishtail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and Facilitated by U.S. Financial Institutions,* Report Prepared by the Permanent Subcomm. on Investigations, Comm. on Governmental Affairs, United States Senate, S. Rpt. 107–82 (2003).

[4] *See* 69 FR 28980, May 19, 2004.

[5] *See* 71 FR 28326, May 16, 2006.

[6] A more detailed summary of the comments on the Initial Proposed Statement, as well as the changes made in response to those comments, is contained in the **Federal Register** notice accompanying the Revised Proposed Statement (71 FR 28326, 28328–29 (May 16, 2006)).

[7] As noted in the Final Statement, financial institutions are encouraged to refer to other supervisory guidance and materials prepared by the Agencies for further information concerning market, credit and operational risk, as well as for further information on legal and reputational risk, internal audit and internal controls.

transaction and new product approval processes, and should provide for elevated risk CSFTs to be reviewed by appropriate levels of control and management personnel at the institution, including personnel from control areas that are independent of the business line(s) involved in the transaction.

The Final Statement—like the Revised Proposed Statement—applies to financial institutions that are engaged in CSFT activities and focuses on those CSFTs that may create heightened levels of legal or reputational risks for a participating financial institution. Because CSFTs typically are conducted by a limited number of large financial institutions, the Final Statement will not affect or apply to the vast majority of financial institutions, including most small institutions.

As the Final Statement recognizes, structured finance transactions encompass a broad array of products with varying levels of complexity. Most structured finance transactions, such as standard public mortgage-backed securities and hedging-type transactions involving ''plain vanilla'' derivatives or collateralized debt obligations, are familiar to participants in the financial markets, have well-established track records, and typically would not be considered CSFTs for purposes of the Final Statement. Some commenters requested that the Agencies provide a more extensive list of structured finance transactions that typically would not be considered CSFTs. The Agencies note that the types of non-complex transactions listed in the Final Statement are only examples of the types of transactions that typically would not be considered CSFTs and that any list of examples would not, and could not, be all inclusive given the changing nature of the structured finance market. Consistent with the principles-based approach of the Final Statement, the Agencies believe the statement appropriately highlights the hallmarks of a non-complex transaction—*i.e.*, a well established track record and familiarity to participants in the financial markets—that may guide institutions and examiners in considering whether a particular type of transaction should be considered a CSFT now or in the future.

A. Identification, Due Diligence, and Approval Processes for Elevated Risk CSFTs

As noted above, a financial institution should establish and maintain policies, procedures and systems that are designed to identify elevated risk CSFTs as part of the institution's transaction or new product approval processes, and to ensure that transactions or new products identified as elevated risk CSFTs are subject to heightened review.[8] In general, a financial institution should conduct the level and amount of due diligence for an elevated risk CSFT that is commensurate with the level of risks identified. A financial institution's policies and procedures should provide that CSFTs identified as potentially having elevated legal or reputational risk are reviewed and approved by appropriate levels of management. The Agencies continue to believe that the designated approval process for elevated risk CSFTs should include the institution's representatives from the relevant business line(s) and/or client relationship management, as well as from appropriate control areas that are independent of the business line(s) involved in the transaction. An institution's policies should provide that new complex structured finance products receive the approval of all relevant control areas that are independent of the profit center before the product is offered to customers.[9]

The Final Statement—like the Revised Proposed Statement—provides examples of transactions that may warrant additional scrutiny by an institution. These examples include, among other things, transactions that appear to the institution to:

- Lack economic substance or business purpose;
- Be designed or used primarily for questionable accounting, regulatory, or tax objectives, particularly when the transactions are executed at year-end or at the end of a reporting period for the customer; or
- Raise concerns that the client will report or disclose the transaction in its public filings or financial statements in a manner that is materially misleading or inconsistent with the substance of the transaction or applicable regulatory or accounting requirements.

A few commenters contended that the examples of elevated risk CSFTs contained in the Revised Proposed Statement have characteristics that are signals, if not conclusive proof, of fraudulent activity, and recommended that the Agencies inform financial institutions that transactions or products with any of these characteristics should be considered presumptively prohibited. The commenters also argued that the statement encourages or condones illegal conduct by financial institutions. The Agencies believe that CSFTs that initially appear to an institution, during the ordinary course of its new product or transaction approval process, to have one or more of the characteristics identified in the Final Statement should generally be identified as an elevated risk CSFT, and the institution should conduct due diligence for the transaction that is commensurate with the level of identified, potential risks. The Agencies, however, do not believe it is appropriate to provide that all transactions initially identified as potentially creating elevated legal or reputational risks for an institution should be considered presumptively prohibited. For example, an institution, after conducting additional due diligence for a transaction initially identified as an elevated risk CSFT, may determine that the transaction does not, in fact, have the characteristics that initially triggered the review. Alternatively, the institution may take steps to address the legal or reputational risks that initially triggered the review. In this regard, the Final Statement expressly provides that, if after evaluating an elevated risk CSFT, a financial institution determines that its participation in the transaction would create significant legal or reputational risks for the institution, the financial institution should take appropriate steps to manage and address these risks. Such steps may include modifying the transaction or conditioning the institution's participation in the transaction upon the receipt of representations or assurances from the customer that reasonably address the heightened risks presented by the transaction.

Importantly, the Final Statement continues to provide that a financial

[8] In response to comments, the Agencies have modified the Final Statement to clarify that a U.S. branch or agency of a foreign bank is not necessarily expected to establish or adopt separate U.S.-based risk management structures or policies for its CSFT activities. In addition, the Agencies believe the Final Statement provides U.S. branches and agencies of foreign banks sufficient flexibility to develop controls, risk management and reporting structures, and lines of authority that are consistent with the internal management structure of U.S. branches and agencies. However, the risk management structure and policies used by a U.S. branch or agency, whether adopted or implemented on a group-wide or stand-alone basis, should be effective in allowing the branch or agency to manage the risks associated with its CSFT activities.

[9] One commenter sought clarification regarding when during the new product approval process a new complex structured finance product should receive the approval of relevant control areas. The Agencies note that the Final Statement is not intended to prevent institutions from engaging in initial or preliminary discussions or negotiations with potential customers about a new complex structured finance product. However, an institution should obtain the necessary approvals for a new complex structured finance product from appropriate control areas before the institution enters into, or becomes obligated to enter into, a transaction with the customer.

institution should decline to participate in an elevated risk CSFT if, after conducting appropriate due diligence and taking appropriate steps to address the risks from the transaction, the institution determines that the transaction presents unacceptable risks to the institution or would result in a violation of applicable laws, regulations or accounting principles.[10] The Final Statement also expressly notes that financial institutions must conduct their activities in accordance with applicable statutes and regulations. The Agencies believe the Final Statement should assist financial institutions engaged in CSFTs in managing the risks associated with these activities and complying with the law, and does not, as some commenters alleged, encourage or condone illegal conduct.

Some commenters also requested that the Agencies enunciate, clarify or modify the legal standards governing the potential liability of a financial institution for participating in a CSFT that is used for fraudulent or illegal purposes. For example, some commenters asked the Agencies to declare that institutions do not have a duty to ensure the accuracy of a client's public filings or accounting. Other commenters asked that the Agencies state that an institution will not be held liable or responsible for a CSFT if the institution has a reasonable degree of confidence that the customer will report or account for the transactions properly. Other commenters expressed concern that the Revised Proposed Statement, or the comments submitted on that document, attempted to alter the current legal standards under which a financial institution may be held liable for fraudulent activity or criminally responsible under the Federal securities law or other laws.

As events in recent years have highlighted, institutions may in certain circumstances bear significant legal or reputational risk from participating in a CSFT. In light of these risks, the Final Statement describes the types of risk management systems and internal controls that may help a financial institution engaged in CSFTs to identify those CSFTs that may pose heightened legal or reputational risk to the institution, and to evaluate, manage, and address those risks. Because the Final Statement represents guidance on the part of the Banking Agencies and a policy statement on the part of the SEC, it does not, by itself, establish any legally enforceable requirements or obligations. Moreover, as the Final Statement expressly provides, it does not create any private rights of action, nor does it alter or expand the legal duties and obligations that a financial institution may have to a customer, its shareholders or other parties under applicable law. Accordingly, the Agencies do not believe it is appropriate or possible to address in the Final Statement these legal concerns expressed by commenters.

B. Documentation

The Final Statement states that a financial institution should create and collect sufficient documentation to, among other things, verify that the institution's policies and procedures related to elevated risk CSFTs are being followed and allow the internal audit function to monitor compliance with those policies and procedures. The Final Statement also provides that, when an institution's policies and procedures require an elevated risk CSFT to be submitted for approval to senior management, the institution should maintain the transaction-related documentation provided to senior management as well as other documentation that reflect management's approval (or disapproval) of the transaction, any conditions imposed by senior management, and the reasons for such action.

Several commenters strongly suggested that the Agencies should eliminate or modify the portions of the statement that provide for a financial institution to maintain certain documentation related to elevated risk CSFTs that are submitted to the institution's senior management for approval (or denial). For example, some commenters argued that institutions should not be required to maintain any documentation for declined transactions. Other commenters expressed concern that this provision was inconsistent with the current practice of financial institutions, would require financial institutions to create new and potentially extensive documentation to memorialize all aspects of the institution's analytical and decision-making process with respect to an elevated risk CSFT, or would require institutions to create or maintain extensive documentation even for transactions that are approved or rejected by junior staff.

As an initial matter, the Agencies note that the Final Statement's provisions regarding documentation for elevated risk CSFTs submitted to senior management for approval (or disapproval) do not apply to transactions that may be reviewed and acted on by more junior personnel in accordance with the institution's policies and procedures. Rather, these provisions apply only to those elevated risk CSFTs that are identified by the institution as potentially involving the greatest degree of risk to the institution and, for this reason, are required to be reviewed by the institution's senior management. The Agencies believe that it is important for institutions to maintain documentation for this category of elevated risk CSFTs, whether approved or declined, that reflects the factors considered by senior management in taking such action. The Agencies believe this type of documentation may be of significant benefit to the institution and to the Agencies in reviewing the effectiveness of the institution's CSFT-related policies, procedures, and internal controls. However, to help address the commenter's concern about potential burden, the Agencies have modified the Final Statement to recognize that the minutes of an institution's reviewing senior management committee may have the information described and to clarify that the documentation for a transaction should reflect the factors considered by senior management in taking action, but does not have to detail every aspect of the institution's legal or business analysis of the transaction.[11]

C. General Risk Management Principles for Elevated Risk CSFTs

The Final Statement—like the Revised Proposed Statement—also describes some of the other key risk management policies and internal controls that financial institutions should have in place for elevated risk CSFTs. For example, the Final Statement provides that the board of directors and senior management of an institution should establish a ''tone at the top'' through both actions and formalized policies that sends a strong message throughout

[10] Some commenters asked the Agencies to clarify that the Final Statement does not necessarily prevent a financial institution from proceeding with a CSFT simply because there may be some ambiguity in how the transaction might be viewed under the law or applicable accounting principles. The Agencies recognize that in certain circumstances ambiguities may exist as to how the law or accounting principles apply to a CSFT, particularly in light of the inherent complexity and rapidly evolving nature of CSFTs. Nevertheless, as discussed in the Final Statement, a financial institution should maintain strong and effective processes and controls designed to determine whether any such ambiguities may create significant legal or reputational risks for the institution and to manage and address those risks as appropriate.

[11] In light of comments, the Agencies have modified the Documentation section of the Statement to clarify that an institution should retain sufficient documentation to establish that it has provided the customer any disclosures concerning an elevated risk CSFT that the institution is otherwise required to provide to the customer.

the financial institution about the importance of compliance with the law and overall good business ethics. The Final Statement also describes the types of training, reporting mechanisms, and audit procedures that institutions should have in place with respect to elevated risk CSFTs. The Final Statement also provides that a financial institution should conduct periodic independent reviews of its CSFT activities to verify and monitor that its policies and controls relating to elevated risk CSFTs are being implemented effectively and that elevated risk CSFTs are accurately identified and receive proper approvals.

In response to comments, the Agencies have modified the Final Statement to clarify that the independent reviews conducted by a financial institution may be performed by the institution's audit department or an independent compliance function within the institution. One commenter also asked the Agencies to state that the proper role of an institution's independent review function is only to confirm that the institution's policies and procedures for elevated risk CSFTs are being followed and that the function should not assess the quality of the decisions made by institution personnel. The Agencies believe that an institution's audit or compliance department should have the flexibility, in appropriate circumstances, to review the decisions made by institution personnel during the review and approval process for elevated risk CSFTs and for this reason have not made the recommended change.

V. Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3506; 5 CFR Part 1320, Appendix A.1), the Agencies reviewed the Final Statement. The Agencies may not conduct or sponsor, and an organization is not required to respond to, this information collection unless it displays a currently valid OMB control number. The Agencies previously determined that certain provisions of the Revised Proposed Statement contained information collection requirements. OMB reviewed and approved the information collections contained in the Revised Proposed Statement for the FDIC, OTS, OCC and SEC; and the Board reviewed the Revised Proposed Statement under the authority delegated to the Board by OMB (5 CFR Part 1320, Appendix A.1).

OMB control numbers:
OCC: 1557–0229.
OTS: 1550–0111.
FRB: 7100–0311.
FDIC: 3064–0148.
SEC: 3235–0622.

Burden Estimates

OCC

Number of Respondents: 21.
Estimated Time per Response: 25 hours.
Total Estimated Annual Burden: 525 hours.

OTS

Number of Respondents: 5.
Estimated Time per Response: 25 hours.
Total Estimated Annual Burden: 125 hours.

Board

Number of Respondents: 20.
Estimated Time per Response: 25 hours.
Total Estimated Annual Burden: 500 hours.

FDIC

Number of Respondents: 5.
Estimated Time per Response: 25 hours.
Total Estimated Annual Burden: 125 hours.

SEC

Number of Respondents: 5.
Estimated Time per Response: 25 hours.
Total Estimated Annual Burden: 125 hours.

No commenters addressed the Agencies' information collection estimates. The Agencies do not believe that the clarifications included in this Final Statement impact the burden estimates previously developed and approved for these information collections. The Agencies have a continuing interest in the public's opinions of our collections of information. At any time, comments regarding the burden estimate, or any other aspect of this collection of information, including suggestions for reducing the burden, may be sent to:

OCC: You should direct your comments to:

Communications Division, Office of the Comptroller of the Currency, Public Information Room, Mailstop 1–5, Attention: 1557–0229, 250 E Street, SW., Washington, DC 20219. In addition, comments may be sent by fax to (202) 874–4448, or by electronic mail to *regs.comments@occ.treas.gov*. You can inspect and photocopy the comments at the OCC's Public Information Room, 250 E Street, SW., Washington, DC 20219. You can make an appointment to inspect the comments by calling (202) 874–5043. Additionally, you should send a copy of your comments to OCC Desk Officer, 1557–0229, by mail to U.S. Office of Management and Budget, 725 17th Street, NW., #10235, Washington, DC 20503, or by fax to (202) 395–6974.

You can request additional information or a copy of the collection from Mary Gottlieb, OCC Clearance Officer, or Camille Dickerson, (202) 874–5090, Legislative and Regulatory Activities Division, Office of the Comptroller of the Currency, 250 E Street, SW., Washington, DC 20219.

OTS: Information Collection Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552; send a facsimile transmission to (202) 906–6518; or send an e-mail to *infocollection.comments@ots.treas.gov*. OTS will post comments and the related index on the OTS Internet site at *http://www.treas.gov*. In addition, interested persons may inspect the comments at the Public Reading Room, 1700 G Street, NW., by appointment. To make an appointment, call (202) 906–5922, send an e-mail to *public.info@ots.treas.gov*, or send a facsimile transmission to (202) 906–7755.

To obtain a copy of the submission to OMB, contact Marilyn K. Burton at *marilyn.burton@ots.treas.gov*, (202) 906–6467, or fax number (202) 906–6518, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552

Board: You may submit comments, identified by FR 4022, by any of the following methods:

- *Agency Web site: http://www.federalreserve.gov.* Follow the instructions for submitting comments at *http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.*
- *Federal eRulemaking Portal: http://www.regulations.gov*. Follow the instructions for submitting comments.
- *E-mail*: *Regs.comments@federalreserve.gov*. Include docket number in the subject line of the message.
- *Fax:* (202) 452–3819 or (202) 452–3102.
- *Mail:* Michelle Long, Federal Reserve Board Clearance Officer (202) 452–3829, Division of Research and Statistics, Board of Governors of the Federal Reserve System, Washington, DC 20551. Telecommunications Device for the Deaf (TDD) users may contact (202) 263–4869, Board of Governors of the Federal Reserve System, Washington, DC 20551.

All public comments are available from the Board's Web site at *http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm* as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP–500 of the Board's Martin Building (20th and C Streets, NW.) between 9 a.m. and 5 p.m. on weekdays.

FDIC: Interested parties are invited to submit written comments to the FDIC concerning the Paperwork Reduction Act implications of this proposal. Such comments should refer to ''Complex Structured Finance Transactions, 3064–0148.'' Comments may be submitted by any of the following methods:

- *http://www.FDIC.gov/regulations/laws/federal/propose.html.*
- *E-mail: comments@FDIC.gov.* Include Complex Structured Financial Transactions, 3064–0148 in the subject line of the message.
- *Mail:* Steven F. Hanft (202) 898–3907, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.
- *Hand Delivery:* Comments may be hand-delivered to the guard station at the rear of the 17th Street Building (located on F Street), on business days between 7 a.m. and 5 p.m.

SEC: You should direct your comments to: Office of Management and Budget, Attention Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 10102, New Executive Office Building, Washington, DC 20503, with a copy sent to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090 with reference to File No. S7–08–06.

The Final Statement follows:

Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities

I. Introduction

Financial markets have grown rapidly over the past decade, and innovations in financial instruments have facilitated the structuring of cash flows and allocation of risk among creditors, borrowers and investors in more efficient ways. Financial derivatives for market and credit risk, asset-backed securities with customized cash flow features, specialized financial conduits that manage pools of assets and other types of structured finance transactions serve important business purposes, such as diversifying risks, allocating cash flows, and reducing cost of capital. As a result, structured finance transactions now are an essential part of U.S. and international capital markets. Financial institutions have played and continue to play an active and important role in the development of structured finance products and markets, including the market for the more complex variations of structured finance products.

When a financial institution participates in a complex structured finance transaction (''CSFT''), it bears the usual market, credit, and operational risks associated with the transaction. In some circumstances, a financial institution also may face heightened legal or reputational risks due to its involvement in a CSFT. For example, in some circumstances, a financial institution may face heightened legal or reputational risk if a customer's regulatory, tax or accounting treatment for a CSFT, or disclosures to investors concerning the CSFT in the customer's public filings or financial statements, do not comply with applicable laws, regulations or accounting principles. Indeed, in some instances, CSFTs have been used to misrepresent a customer's financial condition to investors, regulatory authorities and others. In these situations, investors have been harmed, and financial institutions have incurred significant legal and reputational exposure. In addition to legal risk, reputational risk poses a significant threat to financial institutions because the nature of their business requires them to maintain the confidence of customers, creditors and the general marketplace.

The Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission (the ''Agencies'') have long expected financial institutions to develop and maintain robust control infrastructures that enable them to identify, evaluate and address the risks associated with their business activities. Financial institutions also must conduct their activities in accordance with applicable statutes and regulations.

II. Scope and Purpose of Statement

The Agencies are issuing this Statement to describe the types of risk management principles that we believe may help a financial institution to identify CSFTs that may pose heightened legal or reputational risks to the institution (''elevated risk CSFTs'') and to evaluate, manage and address these risks within the institution's internal control framework.[12]

Structured finance transactions encompass a broad array of products with varying levels of complexity. Most structured finance transactions, such as standard public mortgage-backed securities transactions, public securitizations of retail credit cards, asset-backed commercial paper conduit transactions, and hedging-type transactions involving ''plain vanilla'' derivatives and collateralized loan obligations, are familiar to participants in the financial markets, and these vehicles have a well-established track record. These transactions typically would not be considered CSFTs for the purpose of this Statement.

Because this Statement focuses on sound practices related to CSFTs that may create heightened legal or reputational risks—transactions that typically are conducted by a limited number of large financial institutions—it will not affect or apply to the vast majority of financial institutions, including most small institutions. As in all cases, a financial institution should tailor its internal controls so that they are appropriate in light of the nature, scope, complexity and risks of its activities. Thus, for example, an institution that is actively involved in structuring and offering CSFTs that may create heightened legal or reputational risk for the institution should have a more formalized and detailed control framework than an institution that participates in these types of transactions less frequently. The internal controls and procedures discussed in this Statement are not all inclusive, and, in appropriate circumstances, an institution may find that other controls, policies, or procedures are appropriate in light of its particular CSFT activities.

Because many of the core elements of an effective control infrastructure are the same regardless of the business line involved, this Statement draws heavily on controls and procedures that the Agencies previously have found to be effective in assisting a financial institution to manage and control risks and identifies ways in which these controls and procedures can be

[12] As used in this Statement, the term ''financial institution'' or ''institution'' refers to national banks in the case of the Office of the Comptroller of the Currency; federal and state savings associations and savings and loan holding companies in the case of the Office of Thrift Supervision; state member banks and bank holding companies (other than foreign banking organizations) in the case of the Federal Reserve Board; state nonmember banks in the case of the Federal Deposit Insurance Corporation; and registered broker-dealers and investment advisers in the case of the Securities and Exchange Commission. The U.S. branches and agencies of foreign banks supervised by the Office of the Comptroller, the Federal Reserve Board and the Federal Deposit Insurance Corporation also are considered to be financial institutions for purposes of this Statement.

effectively applied to elevated risk CSFTs. Although this Statement highlights some of the most significant risks associated with elevated risk CSFTs, it is not intended to present a full exposition of all risks associated with these transactions. Financial institutions are encouraged to refer to other supervisory guidance prepared by the Agencies for further information concerning market, credit, operational, legal and reputational risks as well as internal audit and other appropriate internal controls.

This Statement does not create any private rights of action, and does not alter or expand the legal duties and obligations that a financial institution may have to a customer, its shareholders or other third parties under applicable law. At the same time, adherence to the principles discussed in this Statement would not necessarily insulate a financial institution from regulatory action or any liability the institution may have to third parties under applicable law.

III. Identification and Review of Elevated Risk Complex Structured Finance Transactions

A financial institution that engages in CSFTs should maintain a set of formal, written, firm-wide policies and procedures that are designed to allow the institution to identify, evaluate, assess, document, and control the full range of credit, market, operational, legal and reputational risks associated with these transactions. These policies may be developed specifically for CSFTs, or included in the set of broader policies governing the institution generally. A financial institution operating in foreign jurisdictions may tailor its policies and procedures as appropriate to account for, and comply with, the applicable laws, regulations and standards of those jurisdictions.[13]

A financial institution's policies and procedures should establish a clear framework for the review and approval of individual CSFTs. These policies and procedures should set forth the responsibilities of the personnel involved in the origination, structuring, trading, review, approval, documentation, verification, and execution of CSFTs. Financial institutions may find it helpful to incorporate the review of new CSFTs into their existing new product policies. In this regard, a financial institution should define what constitutes a ''new'' complex structured finance product and establish a control process for the approval of such new products. In determining whether a CSFT is new, a financial institution may consider a variety of factors, including whether it contains structural or pricing variations from existing products, whether the product is targeted at a new class of customers, whether it is designed to address a new need of customers, whether it raises significant new legal, compliance or regulatory issues, and whether it or the manner in which it would be offered would materially deviate from standard market practices. An institution's policies should require new complex structured finance products to receive the approval of all relevant control areas that are independent of the profit center before the product is offered to customers.

A. Identifying Elevated Risk CSFTs

As part of its transaction and new product approval controls, a financial institution should establish and maintain policies, procedures and systems to identify elevated risk CSFTs. Because of the potential risks they present to the institution, transactions or new products identified as elevated risk CSFTs should be subject to heightened reviews during the institution's transaction or new product approval processes. Examples of transactions that an institution may determine warrant this additional scrutiny are those that (either individually or collectively) appear to the institution during the ordinary course of its transaction approval or new product approval process to:

- Lack economic substance or business purpose;
- Be designed or used primarily for questionable accounting, regulatory, or tax objectives, particularly when the transactions are executed at year end or at the end of a reporting period for the customer;
- Raise concerns that the client will report or disclose the transaction in its public filings or financial statements in a manner that is materially misleading or inconsistent with the substance of the transaction or applicable regulatory or accounting requirements;
- Involve circular transfers of risk (either between the financial institution and the customer or between the customer and other related parties) that lack economic substance or business purpose;
- Involve oral or undocumented agreements that, when taken into account, would have a material impact on the regulatory, tax, or accounting treatment of the related transaction, or the client's disclosure obligations;[14]
- Have material economic terms that are inconsistent with market norms (*e.g.*, deep ''in the money'' options or historic rate rollovers); or
- Provide the financial institution with compensation that appears substantially disproportionate to the services provided or investment made by the financial institution or to the credit, market or operational risk assumed by the institution.

The examples listed previously are provided for illustrative purposes only, and the policies and procedures established by financial institutions may differ in how they seek to identify elevated risk CSFTs. The goal of each institution's policies and procedures, however, should remain the same—to identify those CSFTs that warrant additional scrutiny in the transaction or new product approval process due to concerns regarding legal or reputational risks.

Financial institutions that structure or market, act as an advisor to a customer regarding, or otherwise play a substantial role in a transaction may have more information concerning the customer's business purpose for the transaction and any special accounting, tax or financial disclosure issues raised by the transaction than institutions that play a more limited role. Thus, the ability of a financial institution to identify the risks associated with an elevated risk CSFT may differ depending on its role.

B. Due Diligence, Approval and Documentation Process for Elevated Risk CSFTs

Having developed a process to identify elevated risk CSFTs, a financial institution should implement policies and procedures to conduct a heightened level of due diligence for these transactions. The financial institution should design these policies and procedures to allow personnel at an appropriate level to understand and evaluate the potential legal or reputational risks presented by the transaction to the institution and to manage and address any heightened

[13] In the case of U.S. branches and agencies of foreign banks, these policies, including management, review and approval requirements, should be coordinated with the foreign bank's group-wide policies developed in accordance with the rules of the foreign bank's home country supervisor and should be consistent with the foreign bank's overall corporate and management structure as well as its framework for risk management and internal controls.

[14] This item is not intended to include traditional, non-binding ''comfort'' letters or assurances provided to financial institutions in the loan process where, for example, the parent of a loan customer states that the customer states that the customer (*i.e.*, the parent's subsidiary) is an integral and important part of the parent's operations.

legal or reputational risks ultimately found to exist with the transaction.

Due Diligence. If a CSFT is identified as an elevated risk CSFT, the institution should carefully evaluate and take appropriate steps to address the risks presented by the transaction with a particular focus on those issues identified as potentially creating heightened levels of legal or reputational risk for the institution. In general, a financial institution should conduct the level and amount of due diligence for an elevated risk CSFT that is commensurate with the level of risks identified. A financial institution that structures or markets an elevated risk CSFT to a customer, or that acts as an advisor to a customer or investors concerning an elevated risk CSFT, may have additional responsibilities under the federal securities laws, the Internal Revenue Code, state fiduciary laws or other laws or regulations and, thus, may have greater legal and reputational risk exposure with respect to an elevated risk CSFT than a financial institution that acts only as a counterparty for the transaction. Accordingly, a financial institution may need to exercise a higher degree of care in conducting its due diligence when the institution structures or markets an elevated risk CSFT or acts as an advisor concerning such a transaction than when the institution plays a more limited role in the transaction.

To appropriately understand and evaluate the potential legal and reputational risks associated with an elevated risk CSFT that a financial institution has identified, the institution may find it useful or necessary to obtain additional information from the customer or to obtain specialized advice from qualified in-house or outside accounting, tax, legal, or other professionals. As with any transaction, an institution should obtain satisfactory responses to its material questions and concerns prior to consummation of a transaction.[15]

In conducting its due diligence for an elevated risk CSFT, a financial institution should independently analyze the potential risks to the institution from both the transaction and the institution's overall relationship with the customer. Institutions should not conclude that a transaction identified as being an elevated risk CSFT involves minimal or manageable risks solely because another financial institution will participate in the transaction or because of the size or sophistication of the customer or counterparty. Moreover, a financial institution should carefully consider whether it would be appropriate to rely on opinions or analyses prepared by or for the customer concerning any significant accounting, tax or legal issues associated with an elevated risk CSFT.

Approval Process. A financial institution's policies and procedures should provide that CSFTs identified as having elevated legal or reputational risk are reviewed and approved by appropriate levels of control and management personnel. The designated approval process for such CSFTs should include representatives from the relevant business line(s) and/or client management, as well as from appropriate control areas that are independent of the business line(s) involved in the transaction. The personnel responsible for approving an elevated risk CSFT on behalf of a financial institution should have sufficient experience, training and stature within the organization to evaluate the legal and reputational risks, as well as the credit, market and operational risks to the institution.

The institution's control framework should have procedures to deliver the necessary or appropriate information to the personnel responsible for reviewing or approving an elevated risk CSFT to allow them to properly perform their duties. Such information may include, for example, the material terms of the transaction, a summary of the institution's relationship with the customer, and a discussion of the significant legal, reputational, credit, market and operational risks presented by the transaction.

Some institutions have established a senior management committee that is designed to involve experienced business executives and senior representatives from all of the relevant control functions within the financial institution (including such groups as independent risk management, tax, accounting, policy, legal, compliance, and financial control) in the oversight and approval of those elevated risk CSFTs that are identified by the institution's personnel as requiring senior management review and approval due to the potential risks associated with the transactions. While this type of management committee may not be appropriate for all financial institutions, a financial institution should establish processes that assist the institution in consistently managing the review and approval of elevated risk CSFTs on a firm-wide basis.[16]

If, after evaluating an elevated risk CSFT, the financial institution determines that its participation in the CSFT would create significant legal or reputational risks for the institution, the institution should take appropriate steps to address those risks. Such actions may include declining to participate in the transaction, or conditioning its participation upon the receipt of representations or assurances from the customer that reasonably address the heightened legal or reputational risks presented by the transaction. Any representations or assurances provided by a customer should be obtained before a transaction is executed and be received from, or approved by, an appropriate level of the customer's management. A financial institution should decline to participate in an elevated risk CSFT if, after conducting appropriate due diligence and taking appropriate steps to address the risks from the transaction, the institution determines that the transaction presents unacceptable risk to the institution or would result in a violation of applicable laws, regulations or accounting principles.

Documentation. The documentation that financial institutions use to support CSFTs is often highly customized for individual transactions and negotiated with the customer. Careful generation, collection and retention of documents associated with elevated risk CSFTs are important control mechanisms that may help an institution monitor and manage the legal, reputational, operational, market, and credit risks associated with the transactions. In addition, sound documentation practices may help reduce unwarranted exposure to the financial institution's reputation.

A financial institution should create and collect sufficient documentation to allow the institution to:

- Document the material terms of the transaction;
- Enforce the material obligations of the counterparties;
- Confirm that the institution has provided the customer any disclosures concerning the transaction that the institution is otherwise required to provide; and
- Verify that the institution's policies and procedures are being followed and allow the internal audit function to

[15] Of course, financial institutions also should ensure that their own accounting for transactions complies with applicable accounting standards, consistently applied.

[16] The control processes that a financial institution establishes for CSFTs should take account of, and be consistent with, any informational barriers established by the institution to manage potential conflicts of interest, insider trading or other concerns.

monitor compliance with those policies and procedures.

When an institution's policies and procedures require an elevated risk CSFT to be submitted for approval to senior management, the institution should maintain the transaction-related documentation provided to senior management as well as other documentation, such as minutes of the relevant senior management committee, that reflect senior management's approval (or disapproval) of the transaction, any conditions imposed by senior management, and the factors considered in taking such action. The institution should retain documents created for elevated risk CSFTs in accordance with its record retention policies and procedures as well as applicable statutes and regulations.

C. Other Risk Management Principles for Elevated Risk CSFTs

General Business Ethics. The board and senior management of a financial institution also should establish a ''tone at the top'' through both actions and formalized policies that sends a strong message throughout the financial institution about the importance of compliance with the law and overall good business ethics. The board and senior management should strive to create a firm-wide corporate culture that is sensitive to ethical or legal issues as well as the potential risks to the financial institution that may arise from unethical or illegal behavior. This kind of culture coupled with appropriate procedures should reinforce business-line ownership of risk identification, and encourage personnel to move ethical or legal concerns regarding elevated risk CSFTs to appropriate levels of management. In appropriate circumstances, financial institutions may also need to consider implementing mechanisms to protect personnel by permitting the confidential disclosure of concerns.[17] As in other areas of financial institution management, compensation and incentive plans should be structured, in the context of elevated risk CSFTs, so that they provide personnel with appropriate incentives to have due regard for the legal, ethical and reputational risk interests of the institution.

Reporting. A financial institution's policies and procedures should provide for the appropriate levels of management and the board of directors to receive sufficient information and reports concerning the institution's elevated risk CSFTs to perform their oversight functions.

Monitoring Compliance with Internal Policies and Procedures. The events of recent years evidence the need for an effective oversight and review program for elevated risk CSFTs. A financial institution's program should provide for periodic independent reviews of its CSFT activities to verify and monitor that its policies and controls relating to elevated risk CSFTs are being implemented effectively and that elevated risk CSFTs are accurately identified and received proper approvals. These independent reviews should be performed by appropriately qualified audit, compliance or other personnel in a manner consistent with the institution's overall framework for compliance monitoring, which should include consideration of issues such as the independence of reviewing personnel from the business line. Such monitoring may include more frequent assessments of the risk arising from elevated risk CSFTs, both individually and within the context of the overall customer relationship, and the results of this monitoring should be provided to an appropriate level of management in the financial institution.

Audit. The internal audit department of any financial institution is integral to its defense against fraud, unauthorized risk taking and damage to the financial institution's reputation. The internal audit department of a financial institution should regularly audit the financial institution's adherence to its own control procedures relating to elevated risk CSFTs, and further assess the adequacy of its policies and procedures related to elevated risk CSFTs. Internal audit should periodically validate that business lines and individual employees are complying with the financial institution's standards for elevated risk CSFTs and appropriately identifying any exceptions. This validation should include transaction testing for elevated risk CSFTs.

Training. An institution should identify relevant personnel who may need specialized training regarding CSFTs to be able to effectively perform their oversight and review responsibilities. Appropriate training on the financial institution's policies and procedures for handling elevated risk CSFTs is critical. Financial institution personnel involved in CSFTs should be familiar with the institution's policies and procedures concerning elevated risk CSFTs, including the processes established by the institution for identification and approval of elevated risk CSFTs and new complex structured finance products and for the elevation of concerns regarding transactions or products to appropriate levels of management. Financial institution personnel involved in CSFTs should be trained to identify and properly handle elevated risk CSFTs that may result in a violation of law.

IV. Conclusion

Structured finance products have become an essential and important part of the U.S. and international capital markets, and financial institutions have played an important role in the development of structured finance markets. In some instances, however, CSFTs have been used to misrepresent a customer's financial condition to investors and others, and financial institutions involved in these transactions have sustained significant legal and reputational harm. In light of the potential legal and reputational risks associated with CSFTs, a financial institution should have effective risk management and internal control systems that are designed to allow the institution to identify elevated risk CSFTs, to evaluate, manage and address the risks arising from such transactions, and to conduct those activities in compliance with applicable law.

Dated: December 12, 2006.

John C. Dugan,

Comptroller of the Currency.

Dated: December 21, 2006.

By the Office of Thrift Supervision.

Scott M. Polakoff,

Deputy Director & Chief Operating Officer.

By order of the Board of Governors of the Federal Reserve System, December 20, 2006.

Jennifer J. Johnson,

Secretary of the Board.

Dated at Washington, DC, the 22nd day of December, 2006.

By order of the Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary.

Dated: January 5, 2007.

By the Securities and Exchange Commission.

Nancy M. Morris,

Secretary.

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[17] The agencies note that the Sarbanes-Oxley Act of 2002 requires companies listed on a national securities exchange or inter-dealer quotation system of a national securities association to establish procedures that enable employees to submit concerns regarding questionable accounting or auditing matters on a confidential, anonymous basis. *See* 15 U.S.C. 78j–1(m).