

DATE: June 4, 2002

SUBJECT: Interagency Advisory on the Unsafe and Unsound Use of Covenants Tied to Supervisory Actions in Securitization Documents (SR 02-14)

HIGHLIGHTS: This advisory alerts banking organization management and boards of directors to the safety and soundness implications of certain covenants included in securitization documents.

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

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

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

actions should be documented and discussed immediately with its Reserve Bank.

DOCUMENT LOCATION: An electronic version of the SR letter, including the advisory, is available under the "SR Letters" section of the Board of Governors' web site:
<http://www.federalreserve.gov/boarddocs/SRLETTERS/2002>

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