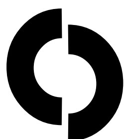

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #959
March 2003

February 13, 2003

Dear **[ ]**:

This letter responds to your letter dated August 6, 2002, concerning the risk weight for tax refund anticipations loans (RALs) and the timing for reporting capital ratios. With respect to the risk weight for RALs, the OCC has determined that 100 percent is the appropriate risk weight for this type of consumer lending. With respect to reporting, capital ratios are regularly reported on each quarterly Consolidated Reports of Condition and Income (Call Report). However, additional reporting requirements, which are described below, apply if a material event occurs that could cause a bank to be placed in a lower capital category.

Background

[ ] (the Bank), has requested that the OCC consider a risk weight of 20 percent for RALs and has provided a legal opinion arguing the case for a lower risk weight.

RALs are bank loans made to individual taxpayers in anticipation of tax refund payments. To apply for a RAL from the Bank, the taxpayer must retain tax preparation services from an IRS-approved *e-file* tax preparer with which the Bank has an agreement, open a deposit account at the Bank, and direct the refund to that account. The account, which the Bank controls, is set up for the sole purpose of receiving the electronic refund from the IRS. The bank account is required because the IRS will not pay a refund to a third party even though the IRS provides guidelines for RAL programs.

The Bank charges a RAL borrower an application fee, a finance charge, and, if applicable, an Earned Income Tax Credit fee. The RAL borrower also pays tax preparation, *e-file*, and other fees to the tax preparer. Based on an average maturity of 10 days, the APRs for RALs with EITC ranged from an estimated 66.15 percent for a $5,000 RAL to an estimated 1880.3 percent for a $100 RAL according to the Bank's 2000 RAL application.

The Bank limits the amount of a RAL to $5,000 and further limits the amount of a RAL covered by an EITC refund to $1,200. The Bank will not make the RAL until the IRS provides a Debt Indicator (DI) that verifies that there are no federal claims outstanding on the tax filer. If the DI

indicates the IRS will offset the tax refund, the Bank rejects the RAL application and only provides the deposit account and refund transfer services. Delinquent RALs from any prior year are deducted from the current refund due per an agreement among other banks that have RAL programs.

Activity in the Bank's RAL program generally begins in mid-January, peaks in early to mid-February, and is virtually completed by the end of March. At the end of the second quarter, the Bank writes off the balances of any outstanding RALs. According to the Bank, past experience indicates that 1.5 percent of RAL borrowers manage to circumvent controls put in place by the IRS and the Bank, which results in losses to the Bank.

In November 2000, the Bank set up a special purpose subsidiary corporation for the purpose of securitizing RALs. In the first quarters of 2001 and 2002, the Bank sold some of its RAL assets into this conduit. By the end of the second quarter in each year, the securitization balances were reduced to zero. In 2002, the Bank retained an 8 percent first loss position in the RAL assets it sold to the conduit.

In the opinion of the Bank's outside counsel, a zero risk weight might be appropriate but counsel does not press the case. Rather, the legal opinion argues for a 20 percent risk weight on the basis that the RAL Program is (1) effectively collateralized by a direct obligation of the U.S. Government and (2) a 20 percent risk weight is prudent and consistent with regulatory intent. The legal opinion argues that the Bank's perfected security interest in the RAL borrower's bank account is the equivalent of an ownership interest in a claim on the U.S. Government. The opinion also suggests that RALs are analogous to general obligations of states and other political subdivisions, instruments conditionally guaranteed by the U.S. government, and obligations guaranteed by Fannie Mae or Freddie Mac. Citing the OCC's reservation of authority[1], the opinion further argues that the OCC can determine that RALs merit a 20 percent risk weight even though the U.S. government does not actually guarantee a RALs transaction.

Discussion

Risk Weights - The OCC's risk-based capital regulations permit a 20 percent risk weight for assets that are "conditionally guaranteed by the United States Government or its agencies"[2] or are "collateralized by cash or securities issued or directly and unconditionally guaranteed by the United States Government or its agencies…[and do] not qualify for the zero percent risk weight category."[3]

Lowering the risk weight on RALs from 100 to 20 percent relies primarily on the OCC's concurrance with the Bank's position that the IRS conditionally guarantees payment of a tax refund claimed by an individual taxpayer, which effectively guarantees the repayment of a RAL. Despite the arguments in the Bank's legal opinion, the Bank's actual loss experience suggests RALs do not perform as if the U.S. government guarantees them. The Bank has taken a number

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[1] 12 C.F.R. Section 3.4(b).
[2] 12 C.F.R. Part 3, Appendix A, Section 3(a)(2)(v).
[3] 12 C.F.R. Part 3, Appendix A, Section 3(a)(2)(iv).

of steps to minimize losses including perfecting a security interest in the deposit account of the RAL borrower, requiring a positive DI from the IRS before making the RAL, providing incentives to tax preparers based on above average-screening of tax returns and RAL applications, and signing the recovery agreement with other banks that offer RALs. Nonetheless, the Bank's losses are larger than would be expected in the case of a U.S. government guaranteed obligation. **[ ]**'s 10Q for March 2002 describes the risks and losses as follows:

> There is a higher credit risk associated with refund loans than with other types of loans because (1) the Company does not have personal contact with the customers of this product; (2) the customers conduct no business with the Company other than this once a year transaction; and (3) contact subsequent to the payment of the advance, if there is a problem with the tax return, may be difficult because many of these taxpayers have no permanent address…. Credit risk has been lowered in the last three years because of the debt indicator provided by the IRS…. However, the charge off rate for RALs still remains approximately five times higher than for the rest of the Company's loan portfolios. (page 43)

Furthermore, the IRS does not compensate the Bank for any losses that it has incurred. In the section of the IRS e-file Handbook that discusses RALs, the IRS specifically states that the "Department of the Treasury is not liable for any loss suffered by taxpayers, EROs, or financial institutions resulting from reduced refunds or Direct Deposits not being honored causing refunds to be issued by check."[4] The IRS also does not recognize the assignment of the payment of individual tax refunds to a third party. The extension of credit through a RAL relies primarily on information provided by the individual filer. If the IRS determines, pursuant to its statutory discretion, that the tax return is not accurate and reduces or denies the expected refund claim, the repayment of the RAL defaults to the individual's creditworthiness. Furthermore, there is no contractual relationship between the Bank and the IRS establishing any form, express or implied, of government guarantee. Accordingly, the Bank's RAL program does not meet collateral or guarantee provisions that would qualify RALs for a 20 percent risk weight. Nor does the RAL program have the characteristics that would make RALs analogous to general obligations of municipalities and assets issued by other entities that qualify for a 20 percent risk weight.

Reporting – In addition to the requirement to report capital levels and ratios in quarterly Call Reports, the OCC's Prompt Corrective Action regulations[5] require notification if a material event occurs that may result in a lowering of the bank's capital level or capital category. If a bank determines that such an event may have lowered its capital category, the bank must notify the OCC in writing within 15 calendar days. The OCC will then determine whether the bank's capital category should be changed and advise the bank accordingly.

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[4] IRS e-file Handbook, Publication 1345 (Rev. 1-2001), Internal Revenue Service, Department of the Treasury, p. 51.

[5] 12 C.F.R. Section 6.3(c).

Conclusion

Based on a review of the Bank's RALs program and the request for a lower risk weight, the OCC has determined that 100 percent is the appropriate risk weight for this type of consumer lending. In an August 6, 2002 letter, the Bank states, "We have been told that we may assign RALs other risk-weightings we consider appropriate when capital ratios are computed at times other than at calendar quarter's end." This is not correct. For regulatory capital purposes, the risk weight for RALs is always 100 percent, whether the calculation is at quarter end or intra-quarter.

Furthermore, if the Bank determines that a material event has occurred that may lower the Bank's capital category, the Bank must notify the OCC within 15 days of that event. The Bank's notification, pursuant to this requirement, that such an event may have occurred does not, in and of itself, constitute in a change in a capital category.

Additional Significant Issue

During our review of your request, an additional significant issue related to the Bank's securitization of RALs came to our attention. Revised risk-based capital rules for asset securitizations were published on November 29, 2001 (66 FR 59614; see OCC Bulletin 2001-49). These rules determine the capital charges that apply when a bank sells an asset and retains a larger than *pro rata* share of the credit risk associated with that asset. Among other things, the revised rules provide for a dollar-for-dollar capital charge on unrated, first loss positions retained on securitized assets. For example, if the Bank sells RAL assets into a conduit and retains a first loss position on its balance sheet, the risk-based capital charge will equal at least the carrying value of the retained position, regardless of the risk-weights of the underlying assets.

If you have questions or need additional information, please contact Nancy Hunt at (202) 874-5070.

Sincerely,

/s/ Tommy Snow

Tommy Snow
Director, Capital Policy