FEDERAL RESERVE BANK
OF DALLAS

WILLIAM H. WALLACE
FIRST VICE PRESIDENT
AND CHIEF OPERATING OFFICER

DALLAS, TEXAS 75222

September 5, 1990

Circular 90-66

TO: The Chief Executive Officer of each member bank and others concerned in the Eleventh Federal Reserve District

SUBJECT

Amendments to Regulations H and Y

DETAILS

The Federal Reserve Board has announced approval in final form of capital to total assets (leverage) guidelines and transitional capital standards for state member banks (Regulation H) and bank holding companies (Regulation Y). These final guidelines are essentially the same as the proposals the Board issued for public comment late last year. The amendments are effective September 10, 1990.

The Board believes these guidelines should assist state member banks and bank holding companies in formulating their capital planning process and in strengthening their capital base.

ATTACHMENT

The Board's notice as it appears on pages 32828-33, Vol. 55, No. 155, of the Federal Register dated Friday, August 10, 1990, is attached.

MORE INFORMATION

For more information, please contact Don Freeman at (214) 744-7408 or Dorsey Davis at (214) 744-7420. For additional copies of this circular, please contact the Public Affairs Department at (214) 651-6289.

Sincerely yours,

William H. Wallace

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FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225

[Regulation H, Regulation Y; Docket No. R-0683]

Capital Adequacy Guidelines; Minimum Tier 1 Leverage Measure and Transition Capital Standards

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: On December 29, 1989, the Board proposed for public comment transition capital guidelines to be applied through the end of 1990, as well as guidelines for a new capital to total assets leverage ratio. The Board is now issuing in final form transition capital standards and capital leverage guidelines that are substantially similar to those proposed. The standards the Board is adopting are minimum requirements. Any institution experiencing or anticipating significant growth would be expected to maintain capital ratios, including tangible capital positions, well above the minimum levels. In all cases, banking institutions should hold capital commensurate with the level and nature of all of the risks, including the volume and severity of problem loans, to which they are exposed.

EFFECTIVE DATE: September 10, 1990.

FOR FURTHER INFORMATION CONTACT: Richard Spillenkothen, Deputy Associate Director (202/452-2594), Roger T. Cole, Assistant Director (202/452-2618), Rhoger H. Pugh, Manager (202/728-5883), or Kelly S. Shaw, Senior Financial Analyst (202/452-3054), Division of Banking Supervision and Regulation, Board of Governors; Michael J. O'Rourke, Senior Attorney (202/452-3288) or Mark J. Tenhundfeld, Attorney (202/452-3612), Legal Division, Board of Governors; or Donald E. Schmid, Manager (212/720-6611) or Manuel J. Schnaidman, Senior Financial Analyst (212/720-6710), Federal Reserve Bank of New York. For the hearing impaired *only*, Telecommunication Device for the Deaf (TDD), Earnestine Hill or Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION:

I. Overview and Summary

When the Board of Governors of the Federal Reserve System ("Board") issued final risk-based capital guidelines on January 19, 1989, it indicated that the existing 5.5 percent and 6 percent primary and total capital to total assets (leverage) ratios would stay in effect at least until the end of 1990, when the interim minimum risk-based capital ratios take effect. The Board also indicated that it would consider proposing a revised leverage constraint that, if adopted, would replace the existing leverage guidelines. It was contemplated that the definition of capital for the new leverage guidelines would be consistent with the risk-based capital definition.

On December 29, 1989, the Board proposed for public comment transition capital guidelines to be applied through the end of 1990, as well as guidelines for a new leverage constraint. The comment period for the Federal Reserve's proposal ended on March 9, 1990. The Board received comments addressing various aspects of the proposal from 45 public commenters.

Based upon the comments received, and further consideration of the issues involved, the Board is now issuing in final form transition capital standards and capital leverage guidelines that are substantially similar to those proposed. The Board believes that adoption of these standards and guidelines should assist state-chartered member banks and bank holding companies (collectively, "banking organizations") in formulating their capital planning process and in strengthening their capital base.

Under the transition capital standards, a banking organization may choose up to the end of 1990 to conform to either the existing minimum capital adequacy ratios (5.5 percent primary capital and 6 percent total capital to total assets) or to the 7.25 percent year-end 1990 risk-based capital standard. The board is also establishing and applying during this period a minimum ratio of 3 percent Tier 1 capital to total assets (leverage ratio). For leverage purposes, Tier 1 is defined consistent with the year-end 1992 risk-based capital guidelines.

The existing 5.5 percent primary and 6.0 percent total capital to total assets leverage ratios will be dropped after year-end 1990. The new Tier 1 leverage ratio will then constitute the minimum capital to total assets standard for banking organizations.

The standards the Board is adopting are minimum requirements. Any institution operating at or near these levels would be expected to have well-diversified risk, including no undue interest rate risk exposure, excellent asset quality, high liquidity, good earnings and, in general, would have to be considered a strong banking organization, rated composite 1 under the appropriate bank or bank holding company rating system. Any institutions experiencing or anticipating significant growth would be expected to maintain capital ratios, including tangible capital positions, well above the minimum levels as has been the case in the past. For example, most such banking organizations generally have operated at capital levels ranging from 100 to 200 basis points above the stated minimums. Higher capital ratios could be required if warranted by the particular circumstances or risk profiles of individual banking organizations. Thus, for all but the most highly-rated institutions meeting the conditions set forth above, the minimum Tier 1 leverage ratio is to be 3 percent plus an additional cushion of at least 100 to 200 basis points. In all cases, banking institutions should hold capital commensurate with the level and nature of all of the risks, including the volume and severity of problem loans, to which they are exposed.

Whenever appropriate, including when an organization is undertaking expansion, seeking to engage in new activities or otherwise facing unusual or abnormal risks, the Board will continue to consider the level of an organization's tangible Tier 1 leverage ratio (after deducting all intangibles) in making an overall assessment of capital adequacy. This is consistent with the Federal Reserve's risk-based capital guidelines and long-standing Board policy and practice under the current leverage guidelines. Organizations experiencing growth, whether internally or by acquisition, are expected to maintain strong capital positions substantially above minimum supervisory levels, without significant reliance on intangible assets.

II. Background

The Federal Reserve's risk-based capital guidelines adopted in January 1989 set forth an interim minimum risk-based ratio effective year-end 1990 and a final minimum risk-based standard effective year-end 1992. In issuing its risk-based capital guidelines, the Board indicated that the existing 5.5 and 6.0 percent primary and total capital to total assets (leverage) ratios would stay in effect, at least until the end of 1990. A principal reason for this was to retain a capital constraint until the interim minimum risk-based capital ratios take effect.

The Board also indicated that even after minimum risk-based capital ratios become effective, retention of an overall leverage constraint might be deemed appropriate because the risk-based capital framework does not incorporate a comprehensive measure of interest rate risk. A minimun ratio of capital to

total assets would help to address this potential problem by imposing an overall limitation on the extent to which a banking organization could leverage its equity capital base.

In addition to interest rate risk, capital ratios may also not take full or explicit account of certain other risk factors that can affect a banking organization's risk profile. These factors include funding and market risks; investment or loan portfolio concentrations; asset quality; and the adequacy of internal policies, systems, and controls. These factors, which must be taken into account in determining the overall risk profile and capital adequacy of a banking organization, also suggest the need to encourage banking organizations to operate well above minimum supervisory ratios.

In issuing its risk-based capital guidelines, the Board indicated that retention of the existing leverage ratios would provide an element of stability during the risk-based capital transition period. The Board further stated that if retention of an overall leverage standard were deemed appropriate in the long-run, the Federal Reserve would consider replacing the existing primary and total capital to total assets leverage ratios with a standard that incorporates a definition of capital that is consistent with the definitions contained in the risk-based capital framework. At the time, the Board indicated that a leverage standard based upon a revised definition of capital, and used in conjunction with a strong risk-based capital requirement, could be set at a level different from the existing leverage standard it would replace.

On December 29, 1989, the Board accordingly proposed for public comment transition capital standards to be applied to state member banks and bank holding companies through the end of 1990, as well as guidelines for a new leverage constraint to be applied to banking organizations, which, if adopted, would replace the existing leverage guidelines. The comment period for the proposal ended March 9, 1990. The Board received comments from 45 public respondents that addressed various aspects of the proposal.[1]

Over 80 percent of the 39 respondents that addressed the proposed leverage guidelines supported the concept of a leverage constraint, although a number had reservations on particular details of the Board's proposed leverage guidelines. Among the issues commenters raised in connection with the leverage constraint was its relationship to banking organizations' CAMEL/BOPEC ratings, the primacy of the risk-based measure, and the definition of capital.

Only nine commenters discussed the Board's proposed transition capital standards. All agreed that the proposal to permit banking organizations a choice of conforming to either the existing minimum capital adequacy ratios or the 7.25 percent year-end 1990 risk-based capital standard would be beneficial.

Based on the comments received and further consideration of the issues involved, the Board is now issuing in final form transition capital guidelines to be applied through the end of 1990, as well as guidelines for a new minimum capital to total assets ratio which will replace the existing leverage guidelines at the end of 1990. These guidelines are substantially similar to those proposed. Taken together, the standards the Board is adopting should assist banking organizations in their capital planning process and, where necessary, their efforts to raise additional capital and strengthen their capital base.

III. Transition and Leverage Standards

A. Transition Standards

The Board proposed transition capital standards to apply during the first phase of the risk-based capital transition period, which ends at year-end 1990. All respondents that commented on this issue endorsed the standards. Accordingly, the Board is issuing the transition capital standards in the form proposed.

Under the adopted transition capital standards, a banking organization may conform to either the existing minimum capital adequacy ratios of 5.5 percent primary capital and 6 percent total capital to total assets, *or* to the 7.25 percent year-end 1990 minimum risk-based capital standard. It should be emphasized that banking organizations are not required to meet the interim risk-based standard prior to its year-end 1990 effective date. Rather, organizations have the option of complying with the risk-based standard during 1990, in lieu of meeting the existing primary and total capital adequacy guidelines. Regardless of which of these options is chosen during this period banking organizations would also have to meet the new proposed leverage standard set forth below.

B. New Leverage Standard

The Board also proposed to establish and apply during 1990 and thereafter a minimum Tier 1 capital to total assets (leverage) ratio of 3 percent. The 3 percent Tier 1 to total assets ratio would be a minimum for the top-rated banking organizations without any supervisory, financial or operational weaknesses or deficiencies. Other organizations would be expected to maintain capital ratios of at least 100 to 200 basis points above the minimum depending on their financial condition. The Board also proposed that at the end of 1990, the Tier 1 leverage ratio would replace the existing 5.5 percent and 6.0 percent primary and total capital to total assets leverage ratios.

The vast majority of commenters, while supporting the use of a leverage constraint, expressed the view that the risk-based capital ratio should serve as the primary measure of an organization's capital adequacy. Commenters were divided on the issue of what would constitute an acceptable minimum level of Tier 1 capital to total assets. Some stated that any minimum over 3 percent would be unduly burdensome and undermine risk-based capital, while others expressed concern that the proposed 3 percent minimum was too low and could lead to an erosion of capital levels. A few respondents endorsed the Board's proposed approach of setting a 3 percent minimum ratio for top-rated organizations and requiring higher capital levels for other organizations because it offered flexibility and placed what they viewed as appropriate reliance on the examination process. A number of commenters, however, stated their concerns that this approach could result in an uneven or inconsistent application of capital standards across organizations and could lead to uncertainty in the capital planning process.

After reviewing the comments received and further considering the issues involved, the Board is adopting its proposal to establish a minimum Tier 1 capital to total assets ratio. This leverage constraint will be used as a supplement to the risk-based capital measure. The Board is also adopting its proposal that the minimum Tier 1 ratio only apply to top-rated organizations without any operating, financial or supervisory deficiencies. Other organizations will be expected to hold an additional capital cushion of at least 100 to 200 basis points, based on their particular circumstances and risk profiles. In the Board's view, this

[1] A summary of the comments received is contained in a memorandum distributed at the Federal Reserve's June 20, 1990 public meeting, at which the board adopted the transition capital standards and leverage guidelines.

approach strikes a reasonable balance between the need to set a floor that is not so high as to undermine the risk-based capital standard, and the need to provide for an adequate limitation on leverage.

The Board proposed that the definition of Tier 1 capital for leverage purposes be consistent with the year-end 1992 risk-based capital definition. A number of commenters endorsed the use of consistent definitions because, in their view, it would minimize confusion and simplify the capital planning process. Some commenters approved the use of Tier 1 capital in the leverage ratio specifically because it would establish an equity standard. A small minority, however, stated their preference for a definition of capital for leverage purposes that would include non-Tier 1 elements such as the allowance for loan and lease losses.

The Board is accordingly adopting its proposal that the leverage standard employ the year-end 1992 definition of Tier 1 capital, as set forth in the risk-based capital guidelines, [2] and exclude any non-Tier 1 elements from its definition of capital. Total assets is defined for this purpose as total consolidated assets (defined net of the allowance for loan and lease losses), less goodwill and, on a case-by-case basis, any other intangible assets or investments in subsidiaries that the primary regulator determines should be deducted from Tier 1 capital.

As proposed, at the end of 1990 the Board will drop the existing leverage ratios, that is, the 5.5 percent and 6.0 percent primary and total capital to total assets leverage ratios. The new Tier 1 capital to total assets ratio will then constitute the leverage standard for banking organizations, and will be used thereafter to supplement the risk-based ratio in determining the overall capital adequacy of banking organizations.

The new Tier 1 leverage ratio differs in a number of respects from the current primary and total capital ratios as defined under the Federal Reserve's existing leverage guidelines. For example, primary capital includes the allowance for loan and lease losses (without limitation), and total capital includes limited amounts of subordinated debt. Neither of these elements, both of which are deemed to be Tier 2 components under the risk-based capital framework, is included in the definition of capital for the new Tier 1 leverage ratio. Moreover, the current primary and total capital leverage standards do not contain an absolute minimum for the level of permanent shareholders' equity in relation to assets—a minimum that is established by the Tier 1 leverage standard. Thus, the new Tier 1 leverage ratio reflects the amount of core equity that is available to support unanticipated losses—a key prudential measure for determining the health of individual banking organizations. In addition to these benefits, adoption of Tier 1 for the purpose of comparing capital to total assets will have the advantage of bringing the definition of capital for leverage purposes into line with the definition of capital for risk-based capital purposes.

The Board emphasizes that in all cases, the standards set forth above are supervisory minimums. An institution operating at or near these levels is expected to have well-diversified risk, including no undue interest rate risk exposure; excellent asset quality; high liquidity; good earnings; and in general be considered a strong banking organization, rated composite 1 under the CAMEL rating system for banks or the BOPEC rating system for bank holding companies. Institutions with high or inordinate levels of risk are expected to operate well above minimum capital standards. As has been the case in the past, institutions experiencing or anticipating significant growth are also expected to maintain capital ratios, including tangible capital positions, well above the minimum levels. For example, most such banking organizations generally have operated at capital levels ranging from 100 to 200 basis points above the stated minimums. Higher capital ratios could be required if warranted by the particular circumstances or risk profiles of individual banking organizations. Thus, for all but the most highly-rated institutions meeting the conditions set forth above, the minimum Tier 1 leverage ratio is to be 3 percent plus an additional cushion of at least 100 to 200 basis points. In all cases, banking institutions should hold capital commensurate with the level and nature of all of the risks, including the volume and severity of problem loans, to which they are exposed.

Whenever appropriate, including when an organization is undertaking expansion, seeking to engage in new activities or otherwise facing unusual or abnormal risks, the Board will continue to consider the level of an organization's tangible Tier 1 leverage ratio (after deducting all intangibles) in making an overall assessment of capital adequacy. This is consistent with the Federal Reserve's risk-based capital guidelines and long-standing Board policy and practice under the current leverage guidelines. Organizations experiencing growth, whether internally or by acquisition, are expected to maintain strong capital positions substantially above minimum supervisory levels, without significant reliance on intangible assets.

IV. Regulatory Flexibility Act Analysis

The Federal Reserve Board certifies that adoption of this proposal would not have a significant economic impact on a substantial number of small business entities (in this case, small banking organizations), in accord with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). In addition, consistent with current policy, these guidelines generally will not apply on a consolidated basis to bank holding companies with consolidated assets of less than $150 million. Moreover, rather than requiring all banking organizations to raise additional capital, the guidelines are directed by institutions whose capital positions are less than fully adequate in relation to their risk and leverage profiles.

List of Subjects

12 CFR Part 208

Accounting, Agricultural loan losses, Applications, Appraisals, Banks, Banking, Branches, Capital adequacy, Confidential business information, Dividend payments, Federal Reserve System, Flood insurance, Publication of reports of condition, Reporting and recordkeeping requirements, Securities, State member banks.

12 CFR Part 225

Administrative practice and procedure, Appraisals, Banks, Banking, Capital adequacy, Federal Reserve System, Holding companies, Reporting

[2] At the end of 1922, Tier 1 capital for state member banks includes common equity, minority interests in equity accounts of consolidated subsidiaries, and qualifying noncumulative perpetual preferred stock, less goodwill. It excludes any other intangible assets and investments in subsidiaries that the Federal Reserve determines should be deducted from capital for supervisory purposes. This could be done on a case-by-case basis or for certain classes of intangible assets. For bank holding companies, Tier 1 capital at the end of 1992 includes common equity, minority interests in equity accounts of consolidated subsidiaries, and qualifying perpetual preferred stock. (Perpetual preferred stock is limited to 25 percent of Tier 1 capital.) In addition, Tier 1 excludes goodwill, and other intangibles and investments in subsidiaries that the primary regulator determines should be deducted from capital. Such deductions could be done on a case-by-case basis or for certain classes of intangible assets. (Ths summary of Tier 1 capital definitions is purely illustrative in nature. Comprehensive Tier 1 capital definitions are set forth in Appendix A to part 208 of the Board's Regulation H for state member banks and in Appendix A to part 225 of the Board's Regulation Y for bank holding companies.)

and recordkeeping requirements, Securities, State member banks.

For the reasons set forth in this document, and pursuant to the Board's authority under section 5(b) of the Bank Holding Company Act of 1956 (12 U.S.C. 1844(b)), and section 910 of the International Lending Supervision Act of 1983 (12 U.S.C. 3909), the Board amends 12 CFR parts 208 and 225 as follows:

PART 208—MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM

1. The authority citation for part 208 continues to read as follows:

Authority: Sections 9, 11(a), 11(c), 19, 21, 25, and 25(a) of the Federal Reserve Act, as amended (12 U.S.C. 321–338, 248(a), 248(c), 461, 481–486, 601, and 611, respectively); sections 4 and 13(j) of the Federal Deposit Insurance Act, as amended (12 U.S.C. 1814 and 1823(j), respectively); section 7(a) of the International Banking Act of 1978 (12 U.S.C. 3105); sections 907–910 of the International Lending Supervision Act of 1983 (12 U.S.C. 3906–3909); sections 2, 12(b), 12(g), 12(i), 15B(c)(5), 17, 17A, and 23 of the Securities Exchange Act of 1934 (15 U.S.C. 78b, 78*l*(b), 78*l*(g), 78*l*(i), 78o–4(c)(5), 78q, 78q–1, and 78w, respectively); section 5155 of the Revised Statutes (12 U.S.C. 36) as amended by the McFadden Act of 1927; and sections 1101–1122 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (12 U.S.C. 3310 and 3331–3351).

2. Section 208.13 is revised to read as follows:

§ 208.13 Capital adequacy.

The standards and guidelines by which the capital adequacy of state member banks will be evaluated by the Board are set forth in appendix A to part 208 for risk-based capital purposes, and, with respect to the ratios relating capital to total assets, in appendix B to part 208 and in appendix B to the Board's Regulation Y, 12 CFR part 225.

Appendix A—[Amended]

3. Footnote 1 to "I. Overview" of appendix A to part 208 is revised to read as follows:

[1] Supervisory ratios that relate capital to total assets for state member banks are outlined in Appendix B of this Part and in appendix B to part 225 of the Federal Reserve's Regulation Y, 12 CFR Part 225.

4. The last sentence of the first paragraph to "IV. Minimum Supervisory Ratios and Standards" of appendix A to part 208 is removed; the existing second paragraph now becomes the third paragraph and remains unchanged; and a new paragraph is added immediately following the first paragraph. The new second paragraph reads as follows:

Institutions with high or inordinate levels of risk are expected to operate well above minimum capital standards. Banks experiencing or anticipating significant growth are also expected to maintain capital, including tangible capital positions, well above the minimum levels. For example, most such institutions generally have operated at capital levels ranging from 100 to 200 basis points above the stated minimums. Higher capital ratios could be required if warranted by the particular circumstances or risk profiles of individual banks. In all cases, banks should hold capital commensurate with the level and nature of all of the risks, including the volume and severity of problem loans, to which they are exposed.

5. A second paragraph is added to "IV. B. Transition Arrangements" of Appendix A to Part 208 to read as follows:

Through year-end 1990, banks have the option of complying with the minimum 7.25 percent year-end 1990 risk-based capital standard, in lieu of the minimum 5.5 percent primary and 6 percent total capital to total assets capital ratios set forth in appendix B to part 225 of the Federal Reserve's Regulation Y. In addition, as more fully set forth in appendix B to this part, banks are expected to maintain a minimum ratio of Tier 1 capital total assets during this transition period.

6. Appendix B is added to part 208 to read as set forth below.

Appendix B To Part 208: Capital Adequacy Guidelines for State Member Banks: Tier 1 Leverage Measure

I. Overview

The Board of Governors of the Federal Reserve System has adopted a minimum ratio to Tier 1 capital to total assets to assist in the assessment of the capital adequacy of state member banks.[1] The principal objective of this measure is to place a constraint on the maximum degree to which a state member bank can leverage its equity capital base. It is intended to be used as a supplement to the risk-based capital measure.

The guidelines apply to all state member banks on a consolidated basis and are to be used in the examination and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. The Board will review the guidelines from time to time and will consider the need for possible adjustments in light of any significant changes in the economy, financial markets, and banking practices.

II. The Tier 1 Leverage Ratio

The Board has established a minimum level of Tier 1 capital to total assets of 3 percent. An institution operating at or near these levels is expected to have well-diversified risk, including no undue interest rate risk exposure; excellent asset quality; high liquidity; good earnings; and in general be considered a strong banking organization, rated composite 1 under the CAMEL rating system of banks. Institutions not meeting these characteristics, as well as institutions with supervisory, financial, or operational weaknesses, are expected to operate well above minimum capital standards. Institutions experiencing or anticipating significant growth also are expected to maintain capital ratios, including tangible capital positions, well above the minimum levels. For example, most such banks generally have operated at capital levels ranging from 100 to 200 basis points above the stated minimums. Higher capital ratios could be required if warranted by the particular circumstances or risk profiles of individual banks. Thus, for all but the most highly-rated banks meeting the conditions set forth above, the minimum Tier 1 leverage ratio is to be 3 percent plus an additional cushion of at least 100 to 200 basis points. In all cases, banking institutions should hold capital commensurate with the level and nature of all risks, including the volume and severity of problem loans, to which they are exposed.

A bank's Tier 1 leverage ratio is calculated by dividing its Tier 1 capital (the numerator of the ratio) by its average total consolidated assets (the denominator of the ratio). The ratio will also be calculated using period-end assets whenever necessary, on a case-by-case basis. For the purpose of this leverage ratio, the definition of Tier 1 capital for year-end 1992 as set forth in the risk-based capital guidelines contained in appendix A of this part will be used.[2] Average total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the bank's Reports of Condition and Income ("Call Report"), less goodwill and any other intangible assets and investments in subsidiaries that the Federal Reserve determines should be deducted from Tier 1 capital.[3]

Whenever appropriate, including when a bank is undertaking expansion, seeking to engage in new activities or otherwise facing unusual or abnormal risks, the Board will continue to consider the level of an individual bank's tangible Tier 1 leverage ratio (after deducting all intangibles) in making an overall assessment of capital adequacy. This is consistent with the Federal Reserve's risk-based capital guidelines and long-standing Board policy and practice with regard to leverage guidelines. Banks experiencing growth, whether internally or by acquisition, are expected to maintain strong capital positions substantially above minimum supervisory levels, without significant reliance on intangible assets.

[1] Supervisory risk-based capital ratios that relate capital to weighted risk assets for state member banks are outlined in Appendix A to this Part.

[2] At the end of 1992, Tier 1 capital for state member banks includes common equity, minority interests in equity accounts of consolidated subsidiaries, and qualifying noncumulative perpetual preferred stock, less goodwill. The Federal Reserve may exclude certain other intangibles and investments in subsidiaries as appropriate.

[3] Deductions from Tier 1 capital and other adjustments are discussed more fully in section II.B. of appendix A to this part.

PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL

1. The authority citation for part 225 continues to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1831i, 1843(c)(8), 1844(b), 3106, 3108, 3907, 3909, 3310, and 3331–3351.

Appendix A—[Amended]

2. Footnote 1 to "I. Overview" of appendix A to part 225 is revised to read as follows:

[1] Supervisory ratios that relate capital to total assets for bank holding companies are outlined in appendices B and D of this part.

3. The last sentence of the first paragraph to "IV. Minimum Supervisory Ratios and Standards" of appendix A to part 225 is removed; the existing second paragraph now becomes the third paragraph and remains unchanged; and a new paragraph is added immediately following the first paragraph. The new second paragraph reads as follows:

Institutions with high or inordinate levels of risk are expected to operate well above minimum capital standards. Banking organizations experiencing or anticipating significant growth are also expected to maintain capital, including tangible capital positions, well above the minimum levels. For example, most such organizations generally have operated at capital levels ranging from 100 to 200 basis points above the stated minimums. Higher capital ratios could be required if warranted by the particular circumstances or risk profiles of individual banking organizations. In all cases, organizations should hold capital commensurate with the level and nature of all of the risks, including the volume and severity of problem loans, to which they are exposed.

4. A second paragraph is added to "IV. B. Transition Arrangements" of appendix A to part 225 to read as follows:

Through year-end 1990, banking organizations have the option of complying with the minimum 7.25 percent year-end 1990 risk-based capital standard, in lieu of the minimum 5.5 percent primary and 6 percent total capital to total assets ratios set forth in appendix B of this Part. In addition, as more fully set forth in appendix D to this part, banking organizations are expected to maintain a minimum ratio of Tier 1 capital to total assets during this transition period.

Appendix B—[Amended]

5. Three new sentences are added to the end of the first paragraph of appendix B to part 225 to read as follows:

* * * In this regard, the Board has determined that during the transition period through year-end 1990 for implementation of the risk-based capital guidelines contained in appendix A to this part and in appendix A to part 208, a banking organization may choose to fulfill the requirements of the guidelines relating capital to total assets contained in this Appendix in one of two manners. Until year-end 1990, a banking organization may choose to conform to either the 5.5 percent and 6 percent minimum primary and total capital standards set forth in this Appendix, or the 7.25 percent year-end 1990 minimum risk-based capital standard set forth in appendix A to this part and appendix A to part 208. Those organizations that choose to conform during this period to the 7.25 percent year-end 1990 risk-based capital standard will be deemed to be in compliance with the capital adequacy guidelines set forth in this appendix.

6. Appendix D is added to part 225 to read as set forth below.

Appendix D—Capital Adequacy Guidelines for Bank Holding Companies: Tier 1 Leverage Measure

I. Overview

The Board of Governors of the Federal Reserve System has adopted a minimum ratio of Tier 1 capital to total assets to assist in the assessment of the capital adequacy of bank holding companies ("banking organizations").[1] The principal objective of this measure is to place a constraint on the maximum degree to which a banking organization can leverage its equity capital base. It is intended to be used as a supplement to the risk-based capital measure.

The guidelines apply on a consolidated basis to bank holding companies with consolidated assets of $150 million or more. For bank holding companies with less than $150 million in consolidated assets, the guidelines will be applied on a bank-only basis unless: a) the parent bank holding company is engaged in nonbank activity involving significant leverage; [2] or b) the parent company has a significant amount of outstanding debt that is held by the general public.

The Tier 1 leverage guidelines are to be used in the inspection and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. The Board will review the guidelines from time to time and will consider the need for possible adjustments in light of any significant changes in the economy, financial markets, and banking practices.

II. The Tier 1 Leverage Ratio

The Board has established a *minimum* level of Tier 1 capital to total assets of 3 percent. A banking organization operating at or near these levels is expected to have well-diversified risk, including no undue interest rate risk exposure; excellent asset quality; high liquidity; good earnings; and in general be considered a strong banking organization, rated composite 1 under the BOPEC rating system for bank holding companies. Organizations not meeting these characteristics, as well as institutions with supervisory, financial, or operational weaknesses, are expected to operate well above minimum capital standards. Organizations experiencing or anticipating significant growth also are expected to maintain capital ratios, including tangible capital positions, well above the minimum levels. For example, most such organizations generally have operated at capital levels ranging from 100 to 200 basis points above the stated minimums. Higher capital ratios could be required if warranted by the particular circumstances or risk profiles of individual banking organizations. Thus, for all but the most highly-rated organizations meeting the conditions set forth above, the minimum Tier 1 leverage ratio is to be 3 percent plus an additional cushion of at least 100 to 200 basis points. In all cases, banking organizations should hold capital commensurate with the level and nature of all risks, including the volume and severity of problem loans, to which they are exposed.

A banking organization's Tier 1 leverage ratio is calculated by dividing its Tier 1 capital (the numerator of the ratio) by its average total consolidated assets (the denominator of the ratio). The ratio will also be calculated on the basis of period-end assets, whenever necessary on a case-by-case basis. For the purpose of this leverage ratio, the definition of Tier 1 capital for year-end 1992 as set forth in the risk-based capital guidelines contained in appendix A to this part will be used.[3] Average total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the banking organization's Consolidated Financial Statements ("FR Y-9C Report"), less goodwill and any other intangible assets or investments in subsidiaries that the Federal Reserve determines should be deducted from Tier 1 capital.[4]

Whenever appropriate, including when an organization is undertaking expansion, seeking to engage in new activities or otherwise facing unusual or abnormal risks, the Board will continue to consider the level of an individual organization's tangible Tier 1 leverage ratio (after deducting all intangibles) in making an overall assessment of capital adequacy. This is consistent with the Federal Reserve's risk-based capital guidelines and long-standing Board policy and practice with regard to leverage guidelines. Organizations experiencing growth, whether internally or by acquisition, are expected to maintain strong

[1] Supervisory risk-based capital ratios that relate capital to weighted risk assets for bank holding companies are outlined in Appendix A to this Part.

[2] A parent company that is engaged in significant off-balance sheet activities would generally be deemed to be engaged in activities that involve significant leverage.

[3] At the end of 1992, Tier 1 capital for bank holding companies includes common equity, minority interests in equity accounts of consolidated subsidiaries, and qualifying perpetual preferred stock. (Perpetual preferred stock is limited to 25 percent of Tier 1 capital.) In addition, Tier 1 excludes goodwill. The Federal Reserve may exclude certain other intangibles and investments in subsidiaries as appropriate.

[4] Deductions from Tier 1 capital and other adjustments are discussed more fully in section II.B. of Appendix A to this Part.

capital positions substantially above minimum supervisory levels, without significant reliance on intangible assets.

By the order of the Board of Governors of the Federal Reserve System, August 1, 1990.

William W. Wiles,

Secretary of the Board.

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