FEDERAL RESERVE BANK
OF DALLAS

ROBERT D. McTEER, JR.
PRESIDENT
AND CHIEF EXECUTIVE OFFICER

March 6, 1992

DALLAS, TEXAS 75222

Notice 92-21

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

SUBJECT

Request for Comments on Proposed Revisions to Capital Adequacy Guidelines

DETAILS

The Federal Reserve Board has issued for public comment a proposal to revise the Board's capital adequacy guidelines for bank holding companies and state member banks. The proposal would provide explicit guidance on the types of intangible assets that may be included in the Tier 1 capital calculation for risk-based and leverage capital purposes. The proposal also includes limits and discounts that would be applicable to such intangibles includable in capital. The proposal is consistent with international capital standards, and was developed in conjunction with the staffs of the four federal banking agencies to achieve greater consistency among the agencies for capital treatment of intangible assets.

The Board must receive comments by March 27, 1992. Comments should be addressed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551. All comments should refer to Docket No. R-0748.

ATTACHMENT

Attached is a copy of the Board's notice as it appears on pages 6563-69, Vol. 57, No. 38, of the Federal Register dated February 26, 1992.

MORE INFORMATION

For more information, please contact Dorsey Davis at (214) 744-7420. For additional copies of this Bank's notice, please contact the Public Affairs Department at (214) 651-6289.

Sincerely yours,

Robert D. McTeer, Jr.

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Proposed Rules

Federal Register
Vol. 57, No. 38
Wednesday, February 26, 1992

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225

[Regulation H, Regulation Y; Docket No. R-0748]

Capital; Capital Adequacy Guidelines

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed revisions to Capital Adequacy Guidelines.

SUMMARY: The Board is proposing to revise its capital adequacy guidelines for bank holding companies and state member banks to provide explicit guidance on the types of intangible assets that may be included in (i.e., not deducted from) the Tier 1 capital calculation for risk-based and leverage capital purposes. The proposal also includes limits and discounts that would be applicable to those intangibles proposed to be included in capital. The proposal, which was developed in conjunction with the staffs of the four federal financial institutions regulatory agenices, is aimed at achieving greater consistency among the agencies with respect to the capital treatment of intangible assets and is being released for public comment on a coordinated basis with these agencies. In addition, certain aspects of the proposal are intended to implement provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991.

DATES: Comments on the proposed revisions to the Federal Reserve Board's risk-based capital guidelines and leverage capital guidelines should be submitted on or before March 27, 1992.

ADDRESSES: Comments, which should refer to Docket No. R-0748, may be mailed to Mr. William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenues, NW., Washington, DC 20551; or delivered to room B-2223, Eccles Building, between 8:45 a.m. and 5:15 p.m. weekdays. Comments may be inspected in Room B-1122 between 9 a.m. and 5 p.m. weekdays, except as provided in § 2612.8 of the Board's Rules Regarding Availability of Information, 12 CFR 261.8.

FOR FURTHER INFORMATION CONTACT: Rhoger H Pugh, Manager (202/728-5883). Norah M. Barger, Supervisory Financial Analyst (202/452-2402), Charles H. Holm, Supervisory Financial Analyst (202/452-3502), Division of Banking Supervision and Regulation; and Scott G. Alvarez, Associate General Counsel (202/452-3583), Legal Division. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION:

I. Background

The Board is proposing to revise the Federal Reserve's capital adequacy guidelines for bank holding companies and state member banks to provide explicit guidance on the types of intangible assets that may be included in (i.e., not deducted from) the Tier 1 capital calculation for risk-based and leverage capital purposes, and the limits and discounts that would be applicable to such intangibles includable in capital. Under the proposal, purchased mortgage servicing rights ("PMSRs") [1] and purchased credit card relationships ("PCCRs") [2] would be includable in the Tier 1 capital computation provided that, in the aggregate, they do not exceed a limit of 50 percent of Tier 1 capital and provided that PCCRs do not exceed a sublimit of 25 percent of Tier 1. PMSRs and PCCRs in excess of these limits, as well as core deposit intangibles ("CDIs") [3] and all other intangible assets, would be deducted from the sum of the core capital elements in determining Tier 1 capital.

The proposal is based on a tentative agreement regarding the treatment of identifiable intangible assets reached by the staffs of the Federal Reserve, the Federal Deposit Insurance Corporation ("FDIC"), the Office of the Comptroller of the Currency ("OCC"), and the Office of Thrift Supervision ("OTS"). It is being released for public comment on a coordinated basis with these other agencies in order to achieve uniformity among the federal financial institutions regulatory agencies in the capital treatment of these assets in a manner that is consistent with the international capital standards (Basle Accord).[4]

The Basle Accord requires that banks deduct goodwill from their core capital elements in determining Tier 1 capital for risk-based capital purposes.[5] The

[1] PMSRs are identifiable intangible assets associated with the right to service mortgage loans. PMSRs generally arise when an institution purchases such rights from another entity that originated the mortgage loans. An organization that acquires PMSRs has the obligation to collect principal and interest payments, and escrow amounts from the mortgagor, and insure that all amounts collected are passed on to the appropriate parties. In return for performing these functions, the servicer receives a fee, which is generally based on the remaining principal amount due on the mortgages being serviced.

[2] PCCRs are identifiable intangible assets asssocated with the right to provide future advances and other services to credit cardholders under credit card arrangements that have been originated by, and purchased from, another entity. PCCRs generally arise when a credit card portfolio is bought and the purchaser acquires the current advances outstanding under the credit card arrangements, which are tangible assets, as well as the right to provide future services to the cardholders, which is an intangible asset. The value of PCCRs derives from the anticipated profit the purchaser will earn from interest on future advances and from fees charged for other future credit card-related services, after covering expenses and other operating costs, such as credit losses.

[3] CDIs are identifiable intangible assets associated with the value of the relatively low cost funding afforded by core depositor relationships (that is, certain nonbrokered retail deposits) acquired from another depository institution. CDIs generally arise when an organization purchases another depository institution or some of its branches and assumes the related deposit liabilities. The value of CDIs is based upon the assumption that the lower cost source of funds provided by core depositor relationships will continue to be available to the acquiring institution for a period of time after the acquisition.

[4] The Basle Accord is a risk-based capital framework that was proposed by the Basle Committee on Banking Regulations and Supervisory Practices and endorsed by the central bank governors of the Group of Ten (G-10) countries in July 1988. The Committee is comprised of representatives of the central banks and supervisory authorities from the G-10 countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, the United Kingdom, and the United States) and Luxembourg

[5] The risk-based capital guidelines utilize the ratio of a banking organization's Tier 1 capital and Tier 2 capital to the organization's total on-balance sheet assets and off-balance sheet credit arrangements, adjusted for their relative risks. Tier 1 capital is composed of core capital elements such as common equity and qualifying perpetual preferred stock, while Tier 2 capital is composed of supplementary capital elements such as the allowance for loan and lease losses and subordinated debt.

Basle framework, which by its terms applies only to internationally active banks, was adopted by the Federal Reserve for all state member banks. The Board also chose to apply, generally on a consolidated basis, a risk-based capital framework similar to the Basle Accord to U.S. bank holding companies.[6] Under this framework, bank holding companies are also required to deduct goodwill from Tier 1 capital. Furthermore, the Board has adopted a leverage capital standard for state member banks and bank holding companies.[7] Since Tier 1 capital serves as the numerator of the leverage ratio, goodwill also is deducted from the core capital elements for purposes of the leverage standard.

The Basle Accord does not address the treatment of identifiable intangible assets, that is, intangible assets other than goodwill. Consequently, under the Basle framework, U.S. bank regulators have discretion in specifying the treatment of these other intangible assets. The basic approach taken by the Federal Reserve and the other U.S. federal financial institutions regulatory agencies in determining the treatment of identifiable intangible assets has been to evaluate them on the basis of the following criteria:

1. The reliability and predictability of any cash flows associated with the asset and the degree of certainty that can be achieved in periodically determining the asset's useful life and value;
2. The marketability of the asset, i.e., the existence of an active and liquid market; and
3. The salability of the asset, i.e., the feasibility of selling the asset apart from the financial institution or from the bulk of its assets.

All the agencies have determined that PMSRs generally meet these criteria and all allow such assets to be included in Tier 1 capital, subject to certain limits. The agencies currently differ on the extent to which other intangibles meet the criteria, and each follows somewhat different procedures regarding their treatment.

The FDIC and OCC fully deduct all intangibles other than PMSRs from Tier 1 capital. The Federal Reserve does not automatically deduct any identifiable intangible asset from Tier 1 capital, but determines the appropriateness of their inclusion in the calculation of an organization's capital position on a case-by-case basis. The Board has long considered the level and quality of identifiable intangible assets in assessing the capital adequacy and overall asset quality of banking institutions since even those intangible assets that meet the above criteria usually contain a relatively high degree of risk. The OTS has concluded that, at least in some cases, certain other identifiable intangible assets (e.g., CDIs) may met the three criteria and, therefore, has not required the deduction of some of these other identifiable intangible assets in calculating capital ratios.

All the agencies specify limits for the amount of intangibles that institutions can include in capital. The OCC permits PMSRs to account for up to 25 percent of Tier 1 capital. The OTS permits PMSRs to be included up to 50 percent of Tier 1 capital, and other qualifying intangibles (e.g., CDIs) are limited to 25 percent of Tier 1 capital. The FDIC permits PMSRs up to 50 percent of Tier 1 capital. Both the OTS and the FDIC impose certain valuation and discounting requirements on PMSRs included in capital. The Board's current risk-based capital guidelines indicated that while all intangible assets will be monitored, identifiable intangible assets in excess of 25 percent of Tier 1 capital are subject to particularly close scrutiny.

For some time, the agencies have been reviewing the capital treatment of identifiable intangible assets with the aim of developing greater uniformity among the agencies in the treatment of these assets for capital adequacy purposes. On the basis of this review, the Board is now proposing to issue for public comment revisions to its capital adequacy guidelines to provide explicit guidance on the types of intangible assets that may be included in capital, namely PMSRs and PCCRs, as well as specifications for appropriate limits on the amount of such assets that may be included within capital. The proposed revisions are based on a tentative agreement reached by the staffs of the four federal financial institutions supervisory agencies with respect to the regulatory capital treatment of intangible assets.

To the extent that PMSRs are determined to be includable in Tier 1 capital, the Federal Reserve is also proposing that these intangible assets be subject to certain valuation requirements that are consistent with provisions of the FDIC Improvement Act of 1991. In that regard, section 475 of the Act provides that the federal banking agencies determine the amount of PMSRs includable in the calculation of an institution's capital, if such servicing rights are valued at not more than 90 percent of their fair market value, and are reviewed at least on a quarterly basis. In addition, the Federal Reserve is proposing that institutions determine the fair market value and book value of PMSRs includable in capital in accordance with criteria already set forth in the current FDIC and OTS rules regarding these intangible assets. Since the calculation of the fair market value for PCCRs is at least as subjective as it is for PMSRs, the Federal Reserve is also proposing that PCCRs be subject to the same valuation requirements as PMSRs.

The proposed changes in the capital treatment of intangible assets would be incorporated into the capital ratios used for both examinations and applications purposes. Consistent with the Board's existing capital guidelines, however, the Board, may in certain cases, continue to evaluate an organization's tangible capital ratios (after deducting all intangibles) in assessing its overall capital adequacy, if warranted in the judgment of the Board.

II. Proposal

The Board is proposing the following treatment for identifiable intangible assets for purposes of the risk-based and leverage capital guidelines:

1. PMSRs and PCCRs would be considered qualifying intangible assets. As such, they would not have to be deducted from capital provided that, in the aggregate, they do not exceed 50 percent of Tier 1 capital and provided that PCCRs do not exceed a sublimit of 25 percent of Tier 1 capital. PMSRs and PCCRs in excess of these limits would be deducted from the core capital elements in determining Tier 1 capital.[8]

2. The limits on PMSRs and PCCRs would be based on a percentage of Tier 1 capital before excess holdings of these assets are deducted, but after goodwill and all other nonqualifying identifiable intangible assets (e.g., CDIs) are deducted.

3. Institutions would be required to determine the fair market value and to review the book value of their PMSRs and PCCRs at least quarterly. Banking organizations that wish to include these assets in capital would not be able to carry them for regulatory reporting

[6] For bank holding companies with consolidated assets of less than $150 million, the risk-based capital guidelines generally are applied on a bank-only basis.

[7] The leverage capital guidelines utilize a ratio of the banking organization's Tier 1 capital elements to its total on-balance sheet assets.

[8] PMSRs and PCCRs that are included in (that is, are not deducted from) capital would be included in the calculation of total risk-weighted assets at a risk weight of 100 percent for risk-based capital purposes and would be included in total average assets for leverage capital purposes. PMSRs and PCCRs that are not included in (that is, are deducted from) capital would not be included in the calculation of total risk-weighted assets for risk-based capital purposes and would be deducted from total average assets for leverage capital purposes.

purposes at a book value that exceeds the discounted value of their estimated future net cash flows.

4. For purposes of calculating Tier 1 capital, the amount of PMSRs and PCCRs an organization could include in capital could not exceed the lesser of 90 percent of the fair market value of the assets, 90 percent of their original purchase price, or 100 percent of their remaining unamortized book value.

5. CDIs and all other identifiable intangible assets would be deducted from the core capital elements for purposes of calculating an institution's Tier 1 capital, just as goodwill, in accordance with the Basle Accord, is deducted.[9]

Including and Limiting PMSRs and PCCRs Within Capital

The Board believes that PMSRs and PCCRs for the most part meet the three criteria the agencies use to evaluate identifiable intangible assets, as outlined in the previous section. Thus, provided that these assets do not exceed specified limits, they generally would not be deducted for purposes of calculating the risk-based and leverage capital ratios.

With regard to the two criteria that pertain to the marketability and salability of intangible assets, the Board believes that markets exist for PMSRs and PCCRs that permit their sale within a relatively short period of time apart from the sale of the banking organization or the bulk of its assets. The Board, however, is proposing to limit the amount of PMSRs and PCCRs includable in capital because of the characteristics of these assets and of the markets in which they are traded.

The market value estimate of PMSRs is based in important part upon expectations about the rate at which the underlying mortgages will prepay. Unexpected and relatively sharp changes in the level of interest rates can cause actual prepayment rates to differ substantially from projected prepayment rates. As a consequence, cash flows generated by PMSRs can vary unpredictably which, in turn, can cause the market value of these assets to change sharply. For example, if interest rates fall to a lower level than expected, a higher than anticipated number of mortgagors may pay off their mortgages in order to refinance their properties at a lower interest rate.When a mortgage is paid off early, the previously anticipated cash flows will no longer be received, and so the servicing right associated with that mortgage becomes valueless. Consequently, if the actual prepayment rate exceeds the expected prepayment rate for a pool of mortgages, the cash flow received from servicing those mortgages and, thus, the market value of the PMSRs associated with that pool, can be greatly reduced. Conversely, if interest rates increase more than anticipated, there may be fewer prepayments than were originally projected. In this case, the related PMSRs may generate greater cash flows than were foreseen at the time of purchase and their value may increase.

The cash flows and values of PMSRs are also affected by the credit quality and operating risks associated with these assets. The servicer is generally obligated to provide a steady cash flow to the owner of the mortgage and undertake normal collection efforts and foreclosure. The costs of fulfilling these obligations when a mortgage becomes delinquent can cause a significant increase in the servicer's collection and administrative expenses, narrowing profit margins. In addition, under some arrangements, known as "recourse" servicing arrangements, the institution that has acquired the PMSRs not only services the loans, but also guarantees their repayment. Such arrangements introduce another level of complexity and uncertainty to the valuation of PMSRs.

The values and cash flows associated with PCCRs, like those associated with PMSRs, are affected by changes in interest rates and credit quality factors. The value and cash flows also can be significantly affected by the amount of future borrowings under credit card lines of credit; the attrition rate (i.e., the rate at which credit cardholders terminate their relationships), which can be accelerated if the bank fails to offer competitive terms and features; and other factors.

The markets for PMSRs and PCCRs are far from perfect. The market for PMSRs is more active and liquid than for PCCRs, but neither approaches a trading volume necessary to qualify as liquid markets. This is reflected in the relatively wide bid/ask spreads quoted by the firms that make markets in PMSRs. Trading in the market for PCCRs is even more infrequent and transactions are customized so that readily available bid/ask quotes are not obtainable. It is possible to sell both types of assets without the delays characteristic of highly imperfect markets, but sales, particularly for PCCRs can take some time and, setting aside potential fluctuations in interest rate or other changes that affect the quality of these assets, there is, given the imperfection of the market, a considerable range of uncertainty concerning the price at which a transaction will occur.

Given the volatility of the cash flows and market values associated with PMSRs and PCCRs, the Board is proposing that the aggregate amount of such assets includable in capital be limited to 50 percent of Tier 1 capital. Furthermore, since estimating the value of PCCRs involves even more assumptions than are required to estimate the value of PMSRs, and the market for PCCRs is less mature and less liquid than the market for PMSRs, the Board is proposing that PCCRs be subject to a separate sublimit of 25 percent of Tier 1 capital. During the period in which this proposal is out for public comment, the Board believes that it would be inadvisable for a banking organization to acquire intangible assets in an amount that would cause its total holdings of identifiable intangible assets, including PMSRs and PCCRs, to exceed 25 percent of Tier 1 capital.

In order to provide for a simple method of calculating these limits, the Board is proposing that the limits be based on a percentage of Tier 1 capital before excess holdings of these assets are deducted, that is, the sum of core capital elements (e.g., common equity and qualifying perpetual preferred stock) less goodwill and other nonqualifying intangible assets. This method of calculation, however, could result in the inclusion in capital of PMSRs and PCCRs in an amount greater than 50 percent, and of PCCRs in an amount greater than 25 percent, of Tier 1 capital net of goodwill, other nonqualifying intangible assets, and deductible amounts of PMSRs and PCCRs. Thus, it would be possible for an institution to report positive Tier 1 capital even though its PMSRs and PCCRs exceed the sum of its core capital elements. Accordingly, the Board is proposing to add cautionary language to its capital adequacy guidelines regarding excessive holdings of intangible assets included in capital, which may be viewed as an unsafe and unsound practice.

Valuation of PMSRs and PCCRs

Section 475 of the FDIC Improvement Act of 1991 provides that the federal banking agencies shall determine the amount of PMSRs includable in the calculation of an institution's capital, if such servicing rights are valued at not

[9] Like goodwill, CDIs and all other intangible assets not includable in capital would not be included in the calculation of total risk-weighted assets for risk-based capital purposes and would be deducted from average total assets for leverage capital purposes.

more than 90 percent of their fair market value, and reviewed at least on a quarterly basis. At present, the FDIC and OTS rules regarding PMSRs require institutions to determine the fair market value of these assets by applying an appropriate market discount rate to the net servicing cash flows, taking into account any significant changes in original valuation assumptions such as prepayment estimates. The FDIC and OTS rules also contain certain requirements with regard to the determination of the book value of PMSRs, which is to be reviewed quarterly. Under these rules, if an institution wishes to include PMSRs assets in regulatory capital, the book value of these assets may not exceed the discounted amount of their estimated future net servicing income.

In order to implement section 475 and in the interest of achieving consistency in the treatment of intangible assets among the agencies, the Board is proposing to require institutions to determine the fair market value and the book value of PMSRs included in capital at least quarterly in accordance with the criteria established by the FDIC and the OTS in their rules regarding PMSRs. If an institution wishes to include such assets in capital, the amount of these assets carried on the balance sheet for regulatory reporting purposes may not exceed the discounted amount of their estimated future net cash flows. The discount rate used for the calculation of book value should not be less than that derived at the time of acquisition, based upon the estimated net cash flows and the price paid for the asset at the time of purchase.

In addition, and consistent with the provisions of section 475, the Board is proposing to use the discounting approach currently employed by the FDIC and the OTS for state nonmember banks and savings associations. Under this approach, for purposes of calculating Tier 1 capital, the amount of PMSRs and PCCRs that an institution could include in capital would be the lesser of:

(i) 90 percent of their fair market value; or

(ii) 90 percent of the original purchase price paid for the assets; or

(iii) 100 percent of their remaining unamortized book value. If both the application of the limit on PMSRs and the adjustment of the balance sheet asset for PMSRs would result in an amount being deducted from capital, the banking organization would deduct only the greater of the two amounts from the sum of its core capital elements in determining Tier 1 capital.

As indicated earlier, the calculation of the fair market value for PCCRs is considered to be at least as subjective as the related calculation is for PMSRs. Consequently, the Board believes the valuation of PCCRs should be subject to the same requirements as those proposed for PMSRs and that these assets should also be discounted. In order to maintain consistency in the valuation of identifiable intangibles included in capital, the Board is proposing that organizations be required to determine the fair market and book value of their PCCRs at least quarterly, using the same criteria as those proposed for PMSRs, and to subject these assets to a value adjustment identical to that proposed for PMSRs.

Deduction of CDIs

The proposal would require a full deduction of other identifiable intangible assets, including CDIs, from Tier 1 capital, which is the same treatment as that accorded to goodwill. This treatment reflects the Board's general conclusion that CDIs have many of the same characteristics as goodwill, which the Basle Accord requires to be deducted from capital.

Although CDIs have value when an organization is financially strong, their value tends to fall significantly when the organization experiences financial difficulty. Depositors who are concerned about the viability of a problem institution are more likely to withdraw their funds, thus diminishing core deposits and the value of the related intangible asset. Moreover, a troubled institution may be required to raise the interest rates on its core deposits along with other sources of funds in order to retain depositors, which in turn can also reduce the value of CDIs. Thus, CDIs provide little protection for an institution in times of stress or for the bank insurance fund if the institution fails. This lack of protection has been evident in closed and assisted transactions handled by the FDIC and the Resolution Trust Corporation ("RTC") where the amount of the premium received on deposit transfer transactions is typically very low.

Moreover, CDIs generally are not purchased apart from the acquisition of a depository institution or one or more branches of a depository institution. Accordingly, CDIs are generally more closely tied to an institution's operations than are its other assets, including the intangibles the Board is proposing to include in capital on a limited basis. This consideration is particularly relevant for an institution experiencing difficulties. When CDIs are sold, of necessity deposit balances must be assumed in connection with the acquisition of deposit account relationships and assets of an amount essentially equivalent to the sum of the deposit balances assumed must be passed to the purchaser. The acquiror ordinarily is only willing to accept high quality assets. Thus, an institution experiencing problems would, if it wished to sell its CDIs, have to give up high quality, relatively liquid assets at a time at which it could be vulnerable to liquidity pressures. In short, CDIs have clear shortcomings relative even to the other identifiable intangible assets, which are proposed to be counted in capital on a limited basis. Furthermore, CDIs are often acquired in a merger along with goodwill. Thus, if CDIs were not deducted from capital, institutions would have an incentive to assign higher amounts of the acquisition cost to CDIs rather than to goodwill.

Active and liquid markets do not exist for CDIs. As a result, their value is derived on the basis of many highly subjective assumptions, which may be difficult for examiners to assess. Such assumptions include the length of time acquired deposits may remain with the acquiring organization, the expected future interest rate on funds generated by the deposits or on alternative sources of funds, and the expected future interest rate and servicing costs on the core deposits.

The Board has not determined that other identifiable intangibles meet the three criteria discussed above that the Board uses to evaluate intangible costs. Accordingly, the Board is proposing to deducted all intangible assets other than PMSRs and PCCRs from Tier 1 for purposes of calculating risk-based and leverage capital ratios.

Questions for Comment

While the Board is seeking public comment on all aspects of its proposal on the capital treatment of identifiable intangible assets, it seeks specific comment on the following questions.

(1) Taking into account the provisions of section 475 of the FDIC Improvement Act of 1991, as well as the current requirements of the FDIC and the OTS with regard to the treatment of these intangible assets proposed to be included in capital, are the approaches proposed for the valuation and discounting of PMSRs and PCCRs appropriate? For example, could a more accurate fair market value for PMSRs and PCCRs be determined by reviewing the prices at which similar assets have sold recently in the market rather than by using the present value of their cash flows as proposed?

(2) How has the large level of mortgage refinancings that have occurred recently affected the market for, and values of, PMSRs? In this regard, commenters are encouraged to provide general market information on PMSRs, as well as other identifiable intangible assets, including the amount of such assets sold and changes in their market value.

(3) Commenters are also encouraged to provide information on the reasons for which banking organizations buy PMSRs, such as for servicing income or for interest rate risk management. Comments are also requested on whether it would be appropriate to limit a banking organization's involvement in PMSRs in relation to its demonstrated ability to incorporate the associated prepayment risk within the organization's overall interest rate risk management system.

(4) Although the proposal does not address the capital treatment of excess servicing rights, these assets carry many of the same risks as PMSRs. Comment therefore is requested on how excess servicing rights should be treated for capital purposes and whether they should be subject to the same limitations as PMSRs.

III. Regulatory Flexibility Act Analysis

The Federal Reserve Board does not believe adoption of this proposal would have a significant economic impact on a substantial number of small 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 this regard, the vast majority of small banking organizations have very limited amounts of identifiable intangible assets, which are the subject of this proposal, as a component of their capital structures. In addition, because the risk-based and leverage capital guidelines generally do not apply to bank holding companies with consolidated assets of less than $150 million, this proposal will not affect such companies.

List of Subjects

12 CFR Part 208

Accounting, Agricultural loan losses, Applications, Appraisals, Banks, Banking, Branches, Capital adequacy, Confidential business information, Currency, 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 and recordkeeping requirements, Securities, State member banks.

For the reasons set forth in this notice, 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 is amending 12 CFR parts 208 and 225 to read 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. Appendix A to part 208 is amended by removing the first three paragraphs of II.B.1.b. and replacing them with seven new paragraphs, to read as follows:

Appendix A to Part 208—Capital Adequacy Guidelines for State Member Banks: Risk-Based Measure

* * * * *

II. * * *

A. * * *

B. * * *

1. a. * * *

b. *Other intangible assets.* In determining the appropriateness of including particular types of intangible assets other than goodwill, that is, identifiable intangible assets, in a bank's capital calculation, the Federal Reserve considers a number of factors, including—

(1) the degree to which the intangible asset has a readily identifiable, predictable, and reliable stream of cash flows and the degree of certainty that the asset will hold this market value notwithstanding the future prospects of the bank;

(2) the existence of an active and liquid market for the intangible asset; and

(3) the ability to sell the intangible asset separate and apart from the bank or from the bulk of the bank's assets.

The Federal Reserve has determined that readily marketable purchased mortgage servicing rights and purchased credit card relationships generally meet these three criteria and, thus, may be included in (that is, not deducted from) a bank's capital, provided that, in the aggregate, the total amount of these assets included in capital does not exceed 50 percent of tier 1 capital. Purchased credit card relationships are subject to a separate sublimit of 25 percent of tier 1 capital. Amounts of purchased mortgage servicing rights and purchased credit card relationships in excess of these limitations, as well as all other identifiable intangible assets, including core deposit intangibles and favorable leaseholds, are to be deducted from a bank's core capital elements in determining tier 1 capital.

For purposes of calculating these limitations, tier 1 capital is defined as the sum of core capital elements, net of goodwill and all identifiable intangible assets other than purchased mortgage servicing rights and purchased credit card relationships. This method of calculation could result in the inclusion in capital of purchased mortgage servicing rights and purchased credit card relationships in an amount greater than 50 percent, and of purchased credit card relationships in an amount greater than 25 percent, of the amount of tier 1 capital used to calculate an institution's capital ratios. In such instances, the Federal Reserve may determine that a bank is operating in an unsafe and unsound manner because of overreliance on intangible assets in tier 1 capital.

Banks must determine the fair market value of intangible assets included in tier 1 capital at least quarterly. The quarterly determination of the fair market value of these intangible assets shall include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates or account attrition rates. The valuation shall be based on an analysis of the current fair market value of the intangible assets, determined by applying an appropriate market discount rate to the expected net cash flows.

Banks must review the book value of intangible assets included in tier 1 capital at least quarterly and make adjustments to these values as necessary. If a bank wishes to include these intangible assets in tier 1 capital, the amount of these assets carried on the balance sheet for regulatory reporting purposes may not exceed the discounted amount of their estimated future net cash flows. At no time should the discount rate used for this calculation be less than that derived at the time of acquisition, based upon the estimated future net cash flows and the original purchase price paid for the asset at the time of purchase. If unanticipated prepayments, account attrition, or other events occur that would reduce the amount of expected future net cash flows from the asset, a writedown of the book value of the

intangible asset should be made to the extent that the discounted amount of future net cash flows is less than the asset's carrying amount. Examiners will review both the book value and the fair market value assigned to these assets, together with supporting documentation, during the examination process.

While a bank that wishes to include purchased mortgage servicing rights and purchased credit card relationships in capital must carry them at a book value that does not exceed the discounted amount of their estimated future net cash flows, for purposes of calculating tier 1 capital, the amount of these assets that may be included in capital shall be the lesser of:

(1) 90 percent of their fair market value, as determined in accordance with this section;

(2) 90 percent of the original purchase price paid for the assets; or

(3) 100 percent of their remaining unamortized book value, as determined in accordance with this section.

If both the application of the limits on purchased mortgage servicing rights and purchased credit card relationships and the adjustment of the balance sheet amount for these intangibles would result in an amount being deducted from capital, the bank would deduct only the greater of the two amounts from its core capital elements in determining tier 1 capital.

Whenever necessary—in particular, when assessing applications to expand or to engage in other activities that could entail unusual or higher-than-normal risks—the Board will, on a case-by-case basis, continue to consider the level of an individual bank's tangible capital ratios (after deducting all intangible assets), together with the quality and value of the bank's tangible and intangible assets, in making an overall assessment of capital adequacy.

* * * * *

2. Appendix B to part 208 is amended by revising footnote 2 and revising the last sentence of the second paragraph in II., to read as follows:

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

* * * * *

[2] At the end of 1992, Tier 1 capital for state member banks includes common equity, minority interests in the equity accounts of consolidated subsidiaries, and qualifying noncumulative perpetual preferred stock. In addition, Tier 1 capital excludes goodwill; amounts of purchased mortgage servicing rights and purchased credit card relationships that, in the aggregate exceed 50 percent of Tier 1 capital; amounts of purchased credit card relationships that exceed 25 percent of Tier 1 capital; and all other intangible assets. The Federal Reserve may exclude certain investments in subsidiaries or associated companies as appropriate.

* * * * *

II. * * *

* * * 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; amounts of purchased mortgage servicing rights and purchased credit card relationships that, in the aggregate, are in excess of 50 percent of Tier 1 capital; amounts of purchased credit card relationships in excess of 25 percent of Tier 1 capital; all other intangible assets; and any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from Tier 1 capital.[3]

* * * * *

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.

2. Appendix A to part 225 is amended by removing the first three paragraphs of II.B.1.b. and replacing them with seven new paragraphs, to read as follows:

Appendix A to Part 225—Capital Adequacy Guidelines for Bank Holding Companies: Risk-Based Measure

* * * * *

II. * * *

A. * * *

B. * * *

1.a. * * *

b. *Other intangible assets.* In determining the appropriateness of including particular types of intangible assets other than goodwill, that is, identifiable intangible assets, in a bank holding company's capital calculation, the Federal Reserve considers a number of factors, including—

(1) the degree to which the intangible asset has a readily identifiable, predictable, and reliable stream of cash flows and the degree of certainty that the asset will hold this market value notwithstanding the future prospects of the banking organization;

(2) the existence of an active and liquid market for the intangible asset; and

(3) the ability to sell the intangible asset separate and apart from the banking organization or from the bulk of the organization's assets.

The Federal Reserve has determined that readily marketable purchased mortgage servicing rights and purchased credit card relationships generally meet these three criteria and, thus, may be included in (that is, not deducted from) a bank holding company's capital, provided that, in the aggregate, the total amount of these assets included in capital does not exceed 50 percent of tier 1 capital. Purchased credit card relationships are subject to a separate sublimit of 25 percent of tier 1 capital. Amounts of purchased mortgage servicing rights and purchased credit card relationships in excess of these limitations, as well as all other identifiable intangible assets, including core deposit intangibles and favorable leaseholds, are to be deducted from a banking organization's core capital elements in determining tier 1 capital.

For purposes of calculating these limitations, tier 1 capital is defined as the sum of core capital elements, net of goodwill and all identifiable intangible assets other than purchased mortgage servicing rights and purchased credit card relationships. This method of calculation could result in the inclusion in capital of purchased mortgage servicing rights and purchased credit card relationships in an amount greater than 50 percent, and of purchased credit card relationships in an amount greater than 25 percent, of the amount of tier 1 capital used to calculate a banking organization's capital ratios. In such instances, the Federal reserve may determine that a banking organization is operating in an unsafe and unsound manner because or overreliance on intangible assets in tier 1 capital.

Banking organizations must determine the fair market value of intangible assets included in tier 1 capital at least quarterly. The quarterly determination of the fair market value of these intangible assets shall include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates or account attrition rates. The valuation shall be based on an analysis of the current fair market value of the intangible assets, determined by applying an appropriate market discount rate to the expected net cash flows.

Banking organizations must review the book value of intangible assets included in tier 1 capital at least quarterly and make adjustments to these values as necessary. If a banking organization wishes to include these intangible assets in tier 1 capital, the amount of these assets carried on the balance sheet for regulatory reporting purposes may not exceed the discounted amount of their estimated future net cash flows. At no time should the discount rate used for this calculation be less than that derived at the time of acquisition, based upon the estimated future net cash flows and the original purchase price paid for the asset at the time of purchase. If unanticipated prepayments, account attrition, or other events occur that would reduce the amount of expected future net cash flows from the asset, a writedown of the book value of the intangible asset should be made to the extent that the discounted amount of future net cash flows is less than the asset's carrying amount. Examiners will review both the book value and the fair market value assigned to these assets, together with supporting documentation, during the inspection process.

While a banking organization that wishes to include purchased mortgage servicing rights and purchased credit card relationships in capital must carry them at a book value that does not exceed the discounted amount of their estimated future

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

net cash flows, for purposes of calculating tier 1 capital, the amount of these assets that may be included in capital shall be the lesser of:

(1) 90 percent of their fair market value, as determined in accordance with this section;

(2) 90 percent of the original purchase price paid for the assets; or

(3) 100 percent of their remaining unamortized book value, as determined in accordance with this section.

If both the application of the limits on purchased mortgage servicing rights and purchased credit card relationships and the adjustment of the balance sheet amount for these intangibles would result in an amount being deducted from capital, the banking organization would deduct only the greater of the two amounts from its core capital elements in determining tier 1 capital.

Whenever necessary—in particular, when assessing applications to expand or to engage in other activities that could entail unusual or higher-than-normal risks—the Board will, on a case-by-case basis, continue to consider the level of an individual banking organization's tangible capital ratios (after deducting all intangible assets), together with the quality and value of the organization's tangible and intangible assets, in making an overall assessment of capital adequacy.

* * * * *

2. Appendix D to part 225 is amended by revising the last two sentences in footnote 3 and revising the last sentence of the second paragraph in II., to read as follows:

Appendix D to Part 225—Capital Adequacy Guidelines for Bank Holding Companies: Tier 1 Leverage Measure

* * * * *

[3] * * * In addition, Tier 1 capital excludes goodwill; amounts of purchased mortgage servicing rights and purchased credit card relationships that, in the aggregate, exceed 50 percent of Tier 1 capital; amounts of purchased credit card relationships that exceed 25 percent of Tier 1 capital; and all other intangible assets. The Federal Reserve may exclude certain investments in subsidiaries or associated companies as appropriate.

* * * * *

II. * * *

* * * 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; amounts of purchased mortgage servicing rights and purchased credit card relationships that, in the aggregate, are in excess of 50 percent of Tier 1 capital; amounts of purchased credit card relationships in excess of 25 percent of Tier 1 capital; all other intangible assets; and any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from Tier 1 capital.[4]

* * * * *

Board of Governors of the Federal Reserve System, February 18, 1992.

William W. Wiles,

Secretary of the Board.

[FR Doc. 92-4127 Filed 2-25-92; 8:45 am]

BILLING CODE 6210-01-M

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