FEDERAL RESERVE BANK
OF DALLAS

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

DALLAS, TEXAS
75265-5906

December 27, 1993

Notice 93-137

TO: The Chief Executive Officer of each state member bank and bank holding company in the Eleventh Federal Reserve District

SUBJECT

Request for Public Comment on Proposal to Amend Risk-based Capital Guidelines

DETAILS

The Federal Reserve Board has requested public comment on a proposal to amend its risk-based capital guidelines for State member banks and bank holding companies to include in Tier 1 capital net unrealized holding gains and losses on securities available for sale. This component of common stockholders' equity was created by the Financial Accounting Standards Board (FASB) Statement No. 115, "Accounting for Certain Investments in Debt Equity Securities."

The Federal Reserve and the other banking agencies previously announced in August 1993 that they were adopting FASB 115 for regulatory reporting purposes as of January 1, 1994, or the beginning of their first fiscal year thereafter, if later. Early adoption is permitted to the extent allowed by FASB 115.

The Board must receive comments by January 21, 1994. 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-0823.

ATTACHMENT

A copy of the Board's notice (Federal Reserve System Docket No. R-0823) is attached.

MORE INFORMATION

For more information, please contact Dorsey Davis at (214) 922-6051. For additional copies of this Bank's notice, please contact the Public Affairs Department at (214) 922-5254.

Sincerely yours,

Robert D. McTeer, Jr.

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225
[Regulations H and Y; Docket No. R-0823]

Capital; Capital Adequacy Guidelines

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule with request for comments.

SUMMARY: The Board of Governors of the Federal Reserve System is proposing to amend its risk-based and leverage capital guidelines for State member banks and bank holding companies to include in Tier 1 capital the net unrealized changes in the value of securities available for sale for purposes of calculating the risk-based and leverage ratios. The proposal is in response to the recently adopted Financial Accounting Standards Board (FASB) Statement Number 115, Accounting for Certain Investments in Debt and Equity Securities, which establishes "net unrealized holding gains and losses on securities available for sale" as a new component of common stockholders' equity. Although the Board's capital guidelines indicate that common stockholders' equity is included in Tier 1 capital, they do not specifically address this new equity account. This proposed rule addresses the treatment of the new account.

DATES: All comments regarding the proposed changes must be submitted on or before January 21, 1993.

ADDRESSES: Comments should refer to Docket No. and may be addressed to Mr. William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th and Constitution Avenue, NW, Washington, DC 20551, or delivered to room B-2223, Eccles Building, between 8:45 a.m. and 5:15 p.m. Comments may be inspected in room MP-500, Martin Building, between 9:00 a.m. and 5:00 p.m. weekdays, except as provided in Section 261.8(a) of the Board's Rules Regarding Availability of Information, 12 CFR 261.8(a).

FOR FURTHER INFORMATION CONTACT: Rhoger H Pugh, Assistant Director (202/728-5883), Arleen E. Lustig, Supervisory Financial Analyst (202/452-2987), and John M. Frech, Supervisory Financial Analyst (202/452-2275), Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Dorothea Thompson (202/452-3544), Board of Governors of the Federal Reserve System, 20th and C Streets, NW, Washington, DC 20551.

SUPPLEMENTARY INFORMATION:

Background

The risk-based capital guidelines adopted by the Federal Reserve Board[1] set forth a definition of Tier 1 capital

[1] The Board's guidelines implement, for State member banks and bank holding companies, the international bank capital (continued...)

that includes common stockholders' equity. The Board's risk-based capital guidelines for State member banks and bank holding companies further state that common stockholders' equity includes (1) common stock, (2) related surplus, and (3) retained earnings, including capital reserves and adjustments for the cumulative effect of foreign currency translation, net of treasury stock. On May 31, 1993, FASB issued a new accounting standard, FASB Statement Number 115 (FASB 115), Accounting for Certain Investments in Debt and Equity Securities, which, in essence, adds a new element to common stockholders' equity by including net unrealized gains and losses on certain securities. The Federal banking agencies have agreed to adopt FASB 115 for regulatory reporting purposes.[2] The adoption of this new accounting standard for regulatory reporting has raised the question whether the Board should include the new component of common stockholders' equity in Tier 1 capital for purposes of calculating risk-based and leverage capital ratios.

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[1](...continued) standards as set forth in the Basle Accord. 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.

[2] All banking organizations should adopt the new FASB 115 accounting standard, both for GAAP and regulatory reporting purposes, as of January 1, 1994, or the beginning of their first fiscal year thereafter, if later. Early adoption of this standard is also permitted to the extent allowable under FASB 115.

FASB 115

Under current Generally Accepted Accounting Principles (GAAP), there are three categories of securities, each of which is subject to a different accounting treatment: (1) "securities held for investment," (2) "trading securities," and (3) "securities held for sale." Under FASB 115, securities held by banking organizations will be divided among three categories: (1) securities held to maturity, a new category that replaces the securities held-for-investment category; (2) the trading securities category, which remains unchanged; and (3) securities available for sale, a new category that replaces the securities held-for-sale category.

Under FASB 115, trading securities continue to be defined as those securities that an institution buys and holds principally for the purpose of selling in the near term. As before, these securities are to be reported at fair value (i.e., generally at market value), with net unrealized changes in their value reported directly in the income statement as part of an institution's earnings.

Traditionally, securities held for investment have been recorded at amortized cost. Under FASB 115, this treatment will continue to be applied to securities held to maturity. However, FASB 115 states that a banking organization may include a security in the held-to-maturity category only if management has expressed "the positive intent and ability to hold the security to maturity."

Under current GAAP, securities held for sale are carried at the lower of cost or market value. Unrealized losses on such securities are reported through earnings and reduce Tier 1 capital. Securities meeting the definition of the new available-for-sale category, (i.e., securities that the institution does not have both a positive intent and ability to hold to maturity, yet does not intend to trade actively as part of its trading account), will be reported at fair value. However, changes in the fair value of securities available for sale will not be included in the income statement, but will be reported, net of tax effects, directly in a separate, newly-established component of common stockholders' equity. Consequently, any unrealized appreciation or depreciation in the value of securities in the available-for-sale category will have no impact on the reported earnings of an institution, but will affect its capital position.

The available-for-sale category is likely to include more securities than are included in the current held-for-sale account. This is because institutions previously could include in the held-for-investment category securities that banking organizations intended to hold for long-term investment purposes, but not necessarily to maturity. Many such securities are now likely to be held in the available-for-sale category, and the new standard describes specific circumstances under which a debt security should be reported in the available-for-sale or trading accounts rather than in the held-to-maturity category. For example, securities that would be sold in response to changes in market interest rates or prepayment rates, or to provide liquidity to meet deposit withdrawal or increased loan demand, would have to be included in the available-for-sale or trading account; they would not be eligible for the held-to-maturity category.

FASB 115 does acknowledge that there may be events that are "isolated, nonrecurring, and unusual" in nature that could not have been reasonably anticipated by management and, thus, would permit the sale or transfer of a held-to-maturity security without necessarily calling into question the institution's intent to hold to maturity other securities carried in this category. FASB 115 notes that such unforeseen events might include certain changes in industry capital requirements, certain changes in tax laws, and evidence of a significant deterioration in the issuer's creditworthiness that would appear to permit sales or transfers without tainting other securities in the held-to-maturity category.

Proposal

The Board is proposing to amend the capital adequacy guidelines for State member banks and bank holding companies to include in Tier 1 capital the new component of common stockholders' equity created by FASB 115. Under this proposed amendment, the net amount of unrealized gains and losses, adjusted for income taxes, from securities held in the available-for-sale account would be included in Tier 1 capital for purposes of calculating both the leverage and risk-based capital ratios.

The Board believes that this proposal is consistent with the intent of section 121 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), which stipulates, consistent with the long-standing policy of the banking agencies, that regulatory accounting standards be no less stringent than GAAP and result in financial reports that accurately reflect the capital of depository institutions. In this regard, the effect on institutions of including net gains and losses or securities available for sale in Tier 1 can perhaps best be evaluated in an economic environment in which banking organizations generally have experienced losses on their securities holdings, rather than gains as is the situation for most institutions at the present time.

The Board also believes that if unrealized gains and losses on securities available for sale were excluded from Tier 1 capital, an incentive could be created for banking organizations to sell their securities that have appreciated to increase Tier 1 capital, while continuing to hold securities that have depreciated without incurring a reduction in Tier 1 capital. An organization engaging in such a practice potentially could overstate its capital and, accordingly, could be subject to examiner criticism.

The rationale put forward by FASB for requiring the marking to market of securities available for sale is that it provides a more realistic and conservative presentation of the value of these securities than would recording them at historical cost. The premise of valuing securities at historical cost is based on the expectation that the securities will be held to maturity, at which time the institution would realize the par value of the securities. Since securities available for sale, like trading securities, are not intended to be held to maturity, valuing them at historical cost would not be as appropriate as marking them to market. Therefore, including the unrealized losses, as well as the unrealized gains, on securities available for sale in Tier 1 capital, is viewed overall as more conservative than not recognizing these changes in value by continuing to carry these securities on a historical cost basis.

The Board notes that in view of the agencies' adoption of FASB 115 for regulatory reporting purposes, additional regulatory burden would be avoided by including the new equity account in capital. Furthermore, if net unrealized changes in the fair value of securities available for sale are included in capital, the asset base used in the calculation of capital ratios would not have to be adjusted to eliminate changes in the fair value of these securities.

It also should be noted that including unrealized changes in the value of securities available for sale in Tier 1 capital, as proposed, would affect the calculation of capital for purposes of a number of laws and regulations that are based, in part, on the institution's capital levels. Such laws and regulations include prompt corrective action (12 CFR, part 208, Subpart B), brokered deposit restrictions (12 CFR 337.6), and the risk-related insurance premium system (12 CFR part 327).

Consistency with the Basle Accord

The Basle capital treatment for changes in the value of assets that are marked to market is well-established in the case of the unrealized changes in the value of trading securities, which are included in Tier 1, and in the cases of the on-balance sheet revaluation reserves of bank premises and the off-balance sheet revaluation reserves of equity securities, both of which are included in Tier 2. The Board believes that including the unrealized changes in the value of securities available for sale in Tier 1 is consistent with international capital standards, as set forth in the Basle Accord.

The principle of marking-to-market securities in the trading account and including the net unrealized changes in value in Tier 1 capital is applied in many countries and has been considered consistent with the Accord since its adoption in 1988. The on-balance sheet revaluation of bank premises is practiced in some countries that have experienced periods of high rates of inflation. Accordingly, accounting standards in many of these countries require all companies, including banks, to revalue their premises on the balance sheet formally and periodically. The Basle Accord includes the associated revaluation reserve in Tier 2 capital. Banking organizations in the U.S. are not permitted to record their bank premises at market value under

U.S. accounting standards and, thus, revaluation reserves associated with bank premises are not an issue for U.S. banking organizations.

The Basle Accord also includes in Tier 2 capital securities revaluation reserves that arise from a off-balance sheet addition to capital of hidden values and that pertain to "those banks whose balance sheets traditionally include very substantial amounts of equities held in their portfolio at historical cost." Many believe that Tier 2 capital treatment is appropriate for equity and premises revaluation reserves and was adopted for these reserves in part to reflect concerns about a banking organization's ability to recognize the indicated market price for securities or other assets for which there are not highly liquid markets.

The Board believes that its proposed Tier 1 capital treatment for unrealized changes in the value of securities available for sale can be viewed as an extension of the capital treatment currently applied to trading securities. Moreover, the Board also notes that, like other elements of Tier 1 capital under the Basle Accord, the net unrealized gains and losses on these securities is separately disclosed as part of common stockholders' equity on an institution's financial statements on an after-tax basis. However, the Board recognizes the importance of maintaining the consistent application of the Basle capital standards and invites comment on this issue.

Request for Public Comment

The Board invites comments on all aspects of this proposed change. In particular, the Board seeks the comments from interested parties on the following:

(1) The extent to which FASB 115 may permit an institution to sell securities from the held-to-maturity account without calling into question the institution's intent or ability to continue to hold other securities reported in that account.

(2) Examples of isolated, nonrecurring, and unusual events involving demands for liquidity that would permit the sale or transfer of held-to-maturity securities.

(3) Alternatives to including net unrealized changes in the value of securities available for sale in Tier 1 capital by:

   (a) excluding all such changes from capital, which would have the same effect as valuing these securities on a historical cost basis;

   (b) including only losses in Tier 1 capital, while not recognizing any gains for capital purposes, which would have the effect of valuing securities available for sale on lower of cost or market basis -- the same treatment that currently pertains to securities held for sale;

   (c) including both the gains and losses in Tier 2 capital; and

   (d) including losses in Tier 1 capital, while including gains in Tier 2 capital.

(4) The extent to which the above alternatives may create an incentive for banking organizations to sell securities that have appreciated to realize the gains in Tier 1 capital, while holding securities that have depreciated to avoid reductions in Tier 1 capital.

(5) The manner for maintaining an Allocated Transfer Risk Reserve (ATRR) for certain foreign debt securities (e.g."Brady Bonds") held as securities available for sale.

In seeking comments, the Board notes that its decision to propose adoption of FASB 115 for regulatory capital purposes should not be viewed as an endorsement of a wider application of market value accounting. The Board has long had concerns that market valuations of many assets are highly subjective and that market value accounting could produce undesirable volatility in earnings. The Board believes that these concerns are mitigated in the case of FASB 115 because the standard applies only to certain investment securities having a readily discernable fair value and because unrealized changes in the fair value of securities available for sale are reflected directly in capital without affecting reported earnings.

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 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, because the risk-based 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, Agriculture, Banks, banking, Confidential business information, Currency, Reporting and recordkeeping requirements, Securities.

12 CFR Part 225

Administrative practice and procedure, Banks, banking, **Holding companies, Reporting and recordkeeping requirements, Securities.**

For the reasons set forth in the preamble, the Board is proposing to amend 12 CFR parts 208 and 225 as follows:

PART 208--MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM (REGULATION H)

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

Authority: 12 U.S.C. 36, 248(a) and (c), 321-338, 461, 481-486, 601, and 611, 1814, 1823(j), 1831o, 1831p-1, 3906-3909, 3310, 3331-3351; 15 U.S.C. 78b, 78o-4(c)(5), 78q, 78q-1, 78w, 781(b), 781(i), and 1781(q).

Appendix A to Part 208 -- [Amended]

2. Appendix A to part 208 is amended by revising section II.A.1.a, to read as follows:

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II. Definition of Qualifying Capital for the Risk-Based Capital Ratio

* * * * *

A. ***

1. ***

a. <u>Common stockholders' equity.</u> Common stockholders' equity includes: common stock; related surplus; net unrealized holding gains and losses on securities available for sale; and retained earnings, including capital reserves and adjustments for the cumulative effect of foreign currency translation, net of any treasury stock.

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PART 225 -- BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL (REGULATION Y)

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

Authority: 12 U.S.C. 1817(j)(13), 1818, 1831i, 1831p-1, 1843(c)(8), 1844(b), 1972(l), 3106, 3108, 3907, 3909, 3310, and 3331-3351 .

APPENDIX A - [Amended]

2. Appendix A to part 225 is amended by revising section II.A.1.a, to read as follows:

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II. DEFINITION OF QUALIFYING CAPITAL FOR THE RISK-BASED CAPITAL RATIO

* * * * *

A. ***

1. ***

a. Common stockholders' equity. Common stockholders' equity includes: common stock; related surplus; net unrealized holding gains and losses on securities available for sale; and retained earnings, including capital reserves and adjustments for the cumulative effect of foreign currency translation, net of any treasury stock.

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Board of Governors of the Federal Reserve System, December 17, 1993.

(signed William W. Wiles)

William W. Wiles
Secretary of the Board