FEDERAL RESERVE BANK
OF DALLAS

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

DALLAS, TEXAS
75265-5906

January 12, 1995

Notice 95-05

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

SUBJECT

Final Amendments to the Risk-based Capital Guidelines

DETAILS

The Board of Governors of the Federal Reserve System has issued final amendments to the risk-based capital guidelines for state member banks and bank holding companies.

Under this final rule, institutions are generally directed not to include in Tier 1 capital the component, "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 and Equity Securities."

Net unrealized losses on marketable equity securities (equity securities with readily determinable fair values), however, will continue to be deducted from Tier 1 capital. This rule has the general effect of valuing available-for-sale securities at amortized cost (based on historical cost), rather than at fair value (generally at market value), for purposes of calculating the risk-based and leverage capital ratios.

ATTACHMENT

A copy of the Board's notice as it appears on pages 63241-45, Vol. 59, No. 235, of the Federal Register dated December 8, 1994, 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.

Rules and Regulations

Federal Register
Vol. 59, No. 235
Thursday, December 8, 1994

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: Final rule.

SUMMARY: The Board of Governors of the Federal Reserve System is amending its risk-based capital guidelines for state member banks and bank holding companies. Under this final rule, institutions are generally directed to not include in regulatory capital the "net unrealized holding gains (losses) on securities available for sale," the new common stockholders' equity account created by Statement of Financial Accounting Standards Number 115 (FAS 115), *Accounting for Certain Investments in Debt and Equity Securities.* Net unrealized losses on marketable equity securities (i.e., equity securities with readily determinable fair values), however, will continue to be deducted from Tier 1 capital. This rule has the general effect of valuing available-for-sale securities at amortized cost (i.e., based on historical cost), rather than at fair value (i.e., generally at market value), for purposes of calculating the risk-based and leverage capital ratios.

EFFECTIVE DATE: December 31, 1994.

FOR FURTHER INFORMATION CONTACT: Rhoger H Pugh, Assistant Director (202/728–5883), Norah M. Barger, Manager (202/452–2402), 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

On December 28, 1993, the Board of Governors issued for public comment a proposal to amend its risk-based capital guidelines [1] for state member banks and bank holding companies to include in Tier 1 capital the "net unrealized holding gains and losses on securities available for sale" (58 FR 68563, December 28, 1993). The proposal would have had the effect of valuing securities available for sale at market value for purposes of calculating the risk-based and leverage capital ratios. In its proposal, the Board offered several alternative treatments, one of which was to not include such net unrealized gains and losses in the calculation of regulatory capital. It is this alternative treatment that the Board is adopting as a final rule. The comment period ended on January 21, 1994.

The proposal was in response to the issuance of FAS 115 on May 31, 1993, which established "net unrealized holding gains (losses) on securities available for sale" as a new element of common stockholders' equity. All banking organizations were required to adopt FAS 115, for both generally accepted accounting principles (GAAP) and regulatory reporting purposes, as of January 1, 1994, or the beginning of their first fiscal year thereafter, if later. Earlier adoption was permitted.

Since the final capital treatment of such net unrealized gains and losses on available-for-sale securities was not in effect by year-end 1993, the Board directed state member banks and bank holding companies to continue calculating the risk-based and leverage capital ratios on a pre-FAS 115 basis. Accordingly, the net unrealized holding gains and losses on available-for-sale debt securities were not included in regulatory capital, and the amortized cost rather than the fair value of available-for-sale debt securities generally continued to be used in the calculation of both capital ratios. Moreover, equity securities with readily determinable fair values continued to be valued at the lower of cost or fair value for regulatory capital purposes. Both the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) followed this interim capital treatment.

FAS 115

FAS 115 divides securities held by banking organizations among three categories: (1) Securities held to maturity; (2) trading account securities; and (3) securities available for sale.

Under FAS 115, trading securities are defined as those securities that an institution buys and holds principally for the purpose of selling in the near term. As under earlier accounting standards, 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.

Under FAS 115, securities held to maturity are to be recorded at amortized cost. However, FAS 115 states that a banking organization may include a security in the held-to-maturity category only if management has "the positive intent and ability to hold the security to maturity."

Securities meeting the definition of the available-for-sale category (i.e., all securities not held for trading that an institution cannot justify categorizing as held-to-maturity) are to be reported at fair value. Changes in the fair value of securities available for sale are to be reported, net of tax effects, directly in a separate component of common stockholders' equity. Consequently, any unrealized appreciation or depreciation in the value of securities in the available-for-sale category has no impact on the reported earnings of an institution, but affects its GAAP equity capital position.

Initial Proposal

In late December 1993, the Board proposed amending the capital adequacy guidelines for state member banks and bank holding companies to

[1] The Board's risk-based capital guidelines implement, for state member banks and bank holding companies, the international bank capital 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.

reflect the provisions of FAS 115 (58 FR 68563, December 28, 1993). Under the proposed amendment, the net amount of unrealized gains and losses, adjusted for the effects of income taxes, on securities held in the available-for-sale account would be included in Tier 1 capital [2] and such securities would be booked at fair value rather than at amortized cost for purposes of calculating the risk-based and leverage capital ratios.

The Board proposed inclusion of net unrealized gains and losses on available-for-sale securities in Tier 1 capital because it would make the definition of Tier 1 capital more equivalent to the GAAP definition of equity capital. In addition, the proposed Tier 1 capital treatment for unrealized changes in the value of securities available for sale could be viewed as an extension of the capital treatment currently applied to net unrealized gains and losses on trading securities, which are recognized in Tier 1 capital. This recognition has long been viewed as consistent with the Basle Accord. Thus, it could be argued that inclusion of unrealized gains and losses on securities available for sale in Tier 1 capital is also consistent with the Basle Accord.

The Board also noted in its initial proposal that the inclusion of net unrealized changes in the value of securities available for sale in Tier 1 capital 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).

While proposing Tier 1 capital treatment for net unrealized gains and losses on available-for-sale securities, the Board also sought public comment on several alternative treatments. The other options included:

(a) Excluding from regulatory capital all changes in the value of securities available for sale, which would have the same effect as valuing these securities on an amortized cost basis;

(b) Including 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;

(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.

Comments Received

The Federal Reserve received letters from 59 public commenters. Comments were received from 17 multinational and large regional banking organizations, 24 community banking organizations, seven foreign banks, six banking trade associations, two state banking supervisors, two consultants, and one law firm. Twenty-one of the public commenters supported the proposal to include "net unrealized holding gains (losses) on securities available for sale," in Tier 1 capital, while 38 opposed the proposal, including all seven foreign banks.

Public commenters opposed to the proposal included 18 out of the 24 community banks, 5 out of the 17 multinational and large regional banking organizations, all seven foreign banking organizations, three banking trade associations, two state banking supervisory organizations, two consultants, and one law firm. Some of the common reasons cited for opposing the proposal included:

(1) The additional volatility to capital resulting from marking-to-market the available-for-sale securities and consequent fluctuations for some institutions in their single borrower lender limits;

(2) The potential for temporary changes in interest rates to have an adverse effect on the risk-based and leverage capital ratios that would result in a lower prompt corrective action category or higher FDIC risk-based insurance premiums;

(3) The distorting effect of applying market value accounting to some items on only one side of the institution's balance sheet, particularly since interest rate changes that cause changes in asset values often give rise to offsetting changes to the value of the deposit base, which existing accounting standards do not recognize; and

(4) The potential for organizations to become critically undercapitalized and subject to closure as a result of temporary changes in the market values of securities that the banking organization has no intention of selling.

All seven foreign banks that commented on the proposal opposed the inclusion of the net unrealized gains and losses on available-for-sale securities in Tier 1 on the grounds that such treatment for the new equity account is inconsistent with the Basle Accord. In their view, this account is more comparable to securities revaluation reserves, which, under the Accord, are substantially discounted and accorded Tier 2 status, rather than disclosed reserves, which receive an unlimited Tier 1 treatment under the Accord.

Twelve of the 17 multinational and large regional banking organizations commented favorably on the proposal, as did three banking trade associations. However, five multinational and large regional banking organizations opposed the proposal citing concerns similar to those given by smaller institutions. The 21 commenters favoring the proposal gave two main reasons for their support:

(1) The proposed Tier 1 treatment of the new account would parallel the GAAP equity treatment for unrealized gains and losses and, thus, institutions could avoid having to maintain two sets of accounting records for available-for-sale securities; and

(2) Tier 1 treatment would be consistent with the intent of section 121 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), which stipulates that regulatory accounting standards be no less stringent than GAAP.

In its proposal, the Board asked for specific comment on six issues. Ten public commenters commented on the first issue, which concerned the extent to which FAS 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 All 10 commenters stated that FAS 115 provides a specific set of circumstances under which banking organizations can sell securities from the held-to-maturity account without tainting the remaining securities in that account.

Seven banking institutions commented on the second issue, which concerned requests for examples of isolated, nonrecurring, and unusual events involving demands for liquidity that would permit the sale or transfer of held-to-maturity securities under FAS 115. The most common examples cited were changes in tax law, deterioration in the credit-worthiness of a security issuer, and natural disasters.

The third issue concerned alternatives to the proposed Tier 1 capital treatment. Twenty-three organizations commented on the alternatives included in the Board's request for public comment. These alternatives included: Excluding all such changes from capital; deducting losses from Tier 1 capital, and either not recognizing any gains for capital purposes or including them in Tier 2

[2] The Board's risk-based capital guidelines set forth a definition of Tier 1 capital that includes common stockholders' equity. These guidelines 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.

capital; and including both the gains and losses in Tier 2 capital.

Of the 23 commenters, six were multinational or large regional banking organizations that supported the proposal. Generally, these organizations did not favor any of the alternatives. However, 13 commenters, including the seven foreign banks that opposed the proposal, stated that they preferred Tier 2 treatment for net unrealized gains and losses on available-for sale securities over Tier 1 treatment. Four commenters preferred not including the net unrealized gains and losses on available-for-sale securities in regulatory capital.

The fourth issue concerned the extent to which the above alternatives might 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. Six commenters offered views on this issue. Most of these commenters felt that including unrealized gains and losses in regulatory capital would provide some disincentive for banks not to pursue such a strategy. Another commenter stated that while the exclusion of the net unrealized gains and losses could lead a company to selectively sell only securities in which it had a gain, the Securities and Exchange Commission (SEC) would question such a practice.

In setting forth the fifth issue, the Board asked commenters to suggest the appropriate manner for maintaining an Allocated Transfer Risk Reserve (ATRR) for certain foreign debt securities (e.g., "Brady Bonds") held as securities available for sale. Three multinational banking institutions responded to this issue. All three organizations stated that the ATRR should not be applied to such foreign securities since such securities are reflected on banks' financial statements at market value.

The last issue concerned the importance of maintaining consistent application of the Basle capital standards. Fourteen banking organizations and associations commented on this issue. Seven commenters, all of which were foreign banks, stated that the proposal to include the new common equity component in Tier 1 was inconsistent with the provisions of the Basle Accord. They stated that Tier 1 treatment could create competitive inequality with international banks. Moreover, they stated that Tier 1 treatment could cause inconsistency between the Tier 1 measure applied to U.S. banks and the Tier 1 measure applied by other banks regulated by different accounting rules, reducing the meaningfulness of the capital adequacy comparisons. However, three banking organizations, all of which supported the Tier 1 proposal, stated that the proposal was consistent with the Basle Accord and, therefore, would not reduce the meaningfulness of comparisons.

Final Rule

After consideration of the public comments and further deliberation on the issues involved, the Board is adopting a final rule that amends the risk-based capital guidelines to explicitly state that net unrealized gains and losses on available-for-sale securities generally are not be included in capital. Under the final rule, however, unrealized losses on marketable equity securities would continue to be deducted from Tier 1 capital. This final rule was developed in close coordination with the other federal banking agencies and results in a capital treatment for net unrealized gains and losses on securities available for sale that is the same as the interim capital treatment agreed to by the agencies in December 1993.

The Board is adopting one of the alternative capital treatments suggested in December 1993 as a final rule rather than the Tier 1 treatment proposed for a number of reasons. First, most commenters opposed the Board's proposal to include the FAS 115 net unrealized gains and losses in risk-based capital calculations because of concerns about the potential volatility in regulatory capital. As discussed under the section entitled "Comments Received," commenters noted that the inclusion of the net unrealized gains and losses on available-for-sale securities would result in fluctuations in regulatory capital due to temporary changes in interest rates. Thus, an institution's capital as calculated for prompt corrective action, risk-based insurance deposit premiums, lending limits, and other limits based on capital would be affected by unrealized changes in the value of securities that it may not intend or need to sell.

Some commenters also expressed concerns about having to reflect in regulatory capital changes in the market value of selected items on one side of the balance sheet but not the other side. In this regard, the Board notes that it and the other banking agencies opposed FAS 115 as representing piecemeal adoption of mark-to-market accounting when it was issued for public comment. By not adopting FAS 115 for regulatory capital purposes, the Board is taking an action that is consistent with the position, which was taken by the agencies at the time FAS 115 was proposed, that the standard could produce distorted financial statements because it marked some balance sheet items to market but ignored changes in the market value of other items, including liabilities, that could have offsetting price changes. In addition, the Board has long opposed proposals to adopt mark-to-market accounting because of the difficulty in determining the market values of various assets and liabilities and the inappropriateness of using this accounting method for institutions that do not actively trade in marketable financial assets.

The Board believes that not including the FAS 115 net unrealized gains and losses in capital is consistent with the Basle Accord, which (except for trading account assets) generally does not permit Tier 1 capital to be increased by unrealized gains on securities. In addition, the Board finds that FDICIA 121's requirement that the accounting principles used in regulatory reports be no less stringent than GAAP does not apply to the Board's definition of regulatory capital. This finding suggests that excluding net gains and losses from regulatory capital is consistent with FDICIA 121. Moreover, consistent with past opinions expressed by the Board, the Board is not convinced that marking to market available-for-sale securities as FAS 115 requires is necessarily a more stringent reporting treatment than valuing such securities at amortized cost. While mark-to-market treatment results in the recognition of unrealized losses in GAAP equity capital, it also permits the unlimited recognition of unrealized gains in such capital

Furthermore, the Board believes that concerns about not deducting net unrealized losses on available-for-sale securities are overstated since the regulatory reports filed by banking organizations that are available to the public have long collected information on the amortized cost and market value of all securities held in their portfolios (including those held as long-term investments). Thus, examiners and analysts can readily take any depreciation, as well as any appreciation, in a banking organization's securities portfolio into consideration in the determination of the institution's overall capital adequacy.

Finally, the Board has decided to continue to deduct net unrealized losses on marketable equity securities since, unlike debt securities, equities have no maturity date and an uncertain final value. This decision is consistent with longstanding supervisory practice.

Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act, the Board hereby certifies that this final rule will not have a significant impact on a substantial number of small business entities (in this case, small banking organizations). The risk-based capital guidelines generally do not apply to bank holding companies with consolidated assets of less than $150 million; thus, the final rule will not affect such companies.

Paperwork Reduction Act and Regulatory Burden

The Board has determined that this final rule will not increase the regulatory paperwork burden of banking organizations pursuant to the provisions of the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*).

Section 302 of the Riegle Community Development and Regulatory Improvement Act of 1994 (Pub. L. 103-325, 108 Stat. 2160) provides that the federal banking agencies must consider the administrative burdens and benefits of any new regulations that impose additional requirements on insured depository institutions. Section 302 also requires such a rule to take effect on the first day of the calendar quarter following final publication of the rule, unless the agency, for good cause, determines an earlier effective date is appropriate.

The new capital rule does not impose any new requirements on depository institutions of bank holding companies for purposes of calculating their risk-based and leverage capital ratios. The amended rule clarifies the capital treatment of a common stockholders' equity component, "net unrealized holding gains (losses) on securities available for sale," created by FAS 115, but does not change current treatment For these reasons, the Board has determined that an effective date of December 31, 1994, is appropriate. For these same reasons, in accordance with 5 U.S.C. 553(d)(3), the Board finds there is good cause not to follow the 30-day notice requirements of 5 U.S.C. 553(d) and to make the rule effective on December 31, 1994.

List of Subjects

12 CFR Part 208

Accounting, Agriculture, Banks, Banking, Confidential business information, Crime, Currency, Federal Reserve System, Mortgages, Reporting and recordkeeping requirements, Securities.

12 CFR Part 225

Administrative practice and procedure, Banks, Banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities.

For the reasons set forth in the preamble, the Board is amending 12 CFR parts 208 and 225 as set forth below:

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

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

Authority: 12 U.S.C. 36, 248(a), 248(c), 321-338a, 371d, 461, 481-486, 601, 611, 1814, 1823(j), 1828(o), 1831o, 1831p-1, 3105, 3310, 3331-3351 and 3906-3909; 15 U.S.C 78b, 78l(b), 78l(g), 78l(i), 78o-4(c)(5), 78q, 78q-1 and 78w; 31 U.S.C. 5318.

2. Appendix A to part 208 is amended by revising sections II.A.1.a. and II.A.2.f to read as follows:

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

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II. * * *

A. * * *

1. * * *

a. *Common stockholders' equity* For purposes of calculating the risk-based capital ratio, common stockholders' equity is limited to common stock; related surplus; and retained earnings, including capital reserves and adjustments for the cumulative effect of foreign currency translation, net of any treasury stock; less net unrealized holding losses on available-for-sale equity securities with readily determinable fair values. For this purpose, net unrealized holding gains on such equity securities and net unrealized holding gains (losses) on available-for-sale debt securities are not included in common stockholders' equity

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f. *Revaluation reserves* i Such reserves reflect the formal balance sheet restatement or revaluation for capital purposes of asset carrying values to reflect current market values. The federal banking agencies generally have not included unrealized asset appreciation in capital ratio calculations, although they have long taken such values into account as a separate factor in assessing the overall financial strength of a bank.

ii. Consistent with long-standing supervisory practice, the excess of market values over book values for assets held by state member banks will generally not be recognized in supplementary capital or in the calculation of the risk-based capital ratio. However, all banks are encouraged to disclose their equivalent of premises (building) and security revaluation reserves. The Federal Reserve will consider any appreciation, as well as any depreciation, in specific asset values as additional considerations in assessing overall capital strength and financial condition.

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

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

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

2. Appendix A to part 225 is amended by revising sections II.A.1.a. and II.A.2.f to read as follows:

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

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II. * * *

A. * * *

1 * * *

a. *Common stockholders' equity* For purposes of calculating the risk-based capital ratio, common stockholders' equity is limited to common stock; related surplus; and retained earnings, including capital reserves and adjustments for the cumulative effect of foreign currency translation, net of any treasury stock, less net unrealized holding losses on available-for-sale equity securities with readily determinable fair values. For this purpose, net unrealized holding gains on such equity securities and net unrealized holding gains (losses) on available-for-sale debt securities are not included in common stockholders' equity

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f. *Revaluation reserves* i. Such reserves reflect the formal balance sheet restatement or revaluation for capital purposes of asset carrying values to reflect current market values. The Federal Reserve generally has not included unrealized asset appreciation in capital ratio calculations, although it has long taken such values into account as a separate factor in assessing the overall financial strength of a banking organization

ii Consistent with long-standing supervisory practice, the excess of market values over book values for assets held by bank holding companies will generally not be recognized in supplementary capital or in the calculation of the risk-based capital ratio. However, all bank holding companies are encouraged to disclose their equivalent of premises (building) and security revaluation reserves. The Federal Reserve will consider any appreciation, as well as any depreciation, in specific asset values as additional considerations in assessing overall capital strength and financial condition.

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Board of Governors of the Federal Reserve System, December 2, 1994.

Barbara R. Lowrey,

Associate Secretary of the Board.

[FR Doc. 94–30156; Filed 12–7–94; 8:45 am]

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