FEDERAL RESERVE BANK
OF DALLAS

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

DALLAS, TEXAS
75265-5906

January 26, 1995

Notice 95-10

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 amendments to the risk-based capital guidelines for state member banks regarding concentration of credit risk and risks of nontraditional activities. The amendments implement Section 305 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) which directs each Federal banking agency to revise its risk-based capital standards to ensure that the standards take adequate account of these risks.

As amended, the risk-based capital guidelines explicitly identify concentrations of credit risk and an institution's ability to manage them as important factors in assessing an institution's overall capital adequacy. The amendments also identify an institution's ability to adequately manage the risks posed by nontraditional activities as an important factor to consider in assessing an institution's overall capital adequacy.

The amendments became effective January 17, 1995. The Board initially approved these amendments on August 3, 1994. Publication of the joint final rule was delayed to reach interagency agreement.

ATTACHMENT

A copy of the Board's notice as it appears on pages 64561-64, Vol. 59, No. 240, of the Federal Register dated December 15, 1994, is attached.

For additional copies, bankers and others are encouraged to use one of the following toll-free numbers in contacting the Federal Reserve Bank of Dallas: Dallas Office (800) 333-4460; El Paso Branch *Intrastate* (800) 592-1631, *Interstate* (800) 351-1012; Houston Branch *Intrastate* (800) 392-4162, *Interstate* (800) 221-0363; San Antonio Branch *Intrastate* (800) 292-5810.

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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.

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Part 3

[Docket No. 94–22]

RIN 1557–AB14

FEDERAL RESERVE SYSTEM

12 CFR Part 208

[Regulation H; Docket No. R–0764]

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 325

RIN 3064–AB15

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

12 CFR Part 567

[No. 94–152]

RIN 1550–AA59

Risk-Based Capital Standards; Concentration of Credit Risk and Risks of Nontraditional Activities

AGENCIES: Office of the Comptroller of the Currency (OCC), Treasury; Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); and Office of Thrift Supervision (OTS), Treasury.

ACTION: Final rule.

SUMMARY: The OCC, the Board, the FDIC and the OTS (collectively "the agencies") are issuing this final rule to implement the portions of section 305 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) that require the agencies to revise their risk-based capital standards for insured depository institutions to ensure that those standards take adequate account of concentration of credit risk and the risks of nontraditional activities. The final rule amends the risk-based capital standards by explicitly identifying concentration of credit risk and certain risks arising from nontraditional activities, as well as an institution's ability to manage these risks, as important factors in assessing an institution's overall capital adequacy.

EFFECTIVE DATE: January 17, 1995.

FOR FURTHER INFORMATION CONTACT:

OCC: For issues relating to concentration of credit risk and the risks of nontraditional activities, Roger Tufts, Senior Economic Advisor (202/874–5070), Office of the Chief National Bank Examiner. For legal issues, Ronald Shimabukuro, Senior Attorney, Bank Operations and Assets Division (202/874–4460), Office of the Comptroller of the Currency, 250 E Street, S.W., Washington, DC 20219.

Board: For issues related to concentration of credit risk, David Wright, Supervisory Financial Analyst, (202/728–5854) and for issues related to the risks of nontraditional activities, William Treacy, Supervisory Financial Analyst, (202/452–3859), Division of Banking Supervision and Regulation; Scott G. Alvarez, Associate General Counsel (202/452–3583), Gregory A. Baer, Managing Senior Counsel (202/452–3236), Legal Division, 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.

FDIC: Daniel M. Gautsch, Examination Specialist (202/898–6912), Stephen G. Pfeifer, Examination Specialist (202/898–8904), Division of Supervision, or Fred S. Carns, Chief, Financial Markets Section, Division of Research and Statistics (202/898–3930). For legal issues, Pamela E. F LeCren, Senior Counsel (202/898–3730) or Claude A. Rollin, Senior Counsel (202/898–3985), Legal Division, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

OTS: John Connolly, Senior Program Manager, Capital Policy (202) 906–6465; Dorene Rosenthal, Senior Attorney, Regulations, Legislation and Opinions Division (202) 906–7268, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

SUPPLEMENTARY INFORMATION:

I. Background

The risk-based capital standards adopted by the agencies tailor an institution's minimum capital requirement to broad categories of credit risk embodied in its assets and off-balance-sheet instruments. These standards require institutions to have total capital equal to at least 8 percent of their risk-weighted assets.[1] Institutions with high or inordinate levels of risk are expected to operate above minimum capital standards. Currently, each agency addresses capital adequacy through a variety of supervisory actions and considers the risks of credit concentrations and nontraditional activities in taking those varied supervisory actions.

Section 305(b) of FDICIA, Pub. L. 102–242 (12 U.S.C. 1828 note), requires the agencies to revise their risk-based capital standards for insured depository institutions to ensure that those standards take adequate account of interest rate risk, concentration of credit risk and the risks of nontraditional activities. This final rule addresses concentration of credit risk and the risks of nontraditional activities. The agencies are addressing interest rate risk through separate rulemakings. *See* OCC, Board and FDIC joint notice of proposed rulemaking, 58 FR 48206 (September 14, 1993) and OTS final rulemaking, 58 FR 45799 (August 31, 1993). In addition, the agencies issued separate final rules to implement the section 305 requirement that risk-based capital standards reflect the actual performance and expected risk of loss of multifamily mortgages.

For the risks related to concentration of credit and nontraditional activities, the agencies published a joint notice of proposed rulemaking on February 22, 1994. *See* 59 FR 8420. The agencies received 54 comments, including duplicate comments among the agencies. A description of the joint proposed rule along with a discussion of the comments follows.

II. Concentration of Credit Risk

A. Proposed Approach

In the joint proposed rule, the agencies stated that it was not currently feasible to quantify the risk related to concentrations of credit for use in a formula-based capital calculation. Although most institutions can identify and track large concentrations of credit risk by individual or related groups of borrowers, and some can identify concentrations by industry, geographic area, country, loan type or other relevant factors, there is no generally accepted approach to identifying and quantifying the magnitude of risk associated with concentrations of credit. In particular, definitions and analyses of concentrations are not uniform within the industry and are based in part on the subjective judgments of each institution using its experience and knowledge of its specific borrowers, market areas and products.

Nonetheless, techniques do exist to identify broad classes of concentrations

[1] As defined, risk-weighted assets include credit exposures contained in off-balance-sheet instruments.

and to recognize significant exposures. The effective tracking and management of such risk is important to ensuring the safety and soundness of financial institutions. Institutions with significant concentrations of credit risk require capital above the regulatory minimums. As new developments in identifying and measuring concentration of credit risk emerge, the agencies will consider potential refinements to the risk-based capital standards.

Accordingly, the agencies proposed to take account of concentration of credit risk in their risk-based capital guidelines or regulations by amending the standards to explicitly cite concentrations of credit risk and an institution's ability to monitor and control them as important factors in assessing an institution's overall capital adequacy. The joint proposed rule contemplated that in addition to reviewing concentrations of credit risk pursuant to section 305, the agencies also may review an institution's management of concentrations of credit risk for adequacy and consistency with safety and soundness standards regarding internal controls, credit underwriting or other relevant operational and managerial areas to be promulgated pursuant to section 132 of FDICIA.

B. Comments

The vast majority of commenters supported the agencies' decision not to propose any quantitative formula or standard. Many commenters, however, expressed a general concern as to how the agencies would implement and interpret the joint proposed rule. Commenters noted with approval the agencies' observation that rulemaking in this area could inadvertently create false incentives or unintended consequences that might decrease the safety and soundness of the banking and thrift industries or unnecessarily reduce the availability of credit to potential borrowers. Several commenters, particularly smaller banks, agreed with the agencies that, while portfolio diversification is a desirable goal, it may also increase an institution's overall risk if accomplished by lending in unfamiliar market areas to out-of-territory borrowers or by rapid expansion of new loan products for which the institution does not have adequate expertise.

A significant number of commenters went further, however, suggesting that any requirement for institutions to hold additional capital for significant concentrations of credit risk, including the case-by-case approach proposed by the agencies, would hurt small banks with limited portfolios and would encourage unhealthy diversification. Under the "Qualified Thrift Lender" test, for example, thrifts must hold 65 percent of their assets in qualifying categories. This requirement necessarily "concentrates" a thrift's portfolio in certain types of assets. Agricultural banks described their position as similar, and therefore opposed any requirement of additional capital in order to compensate for exposures to concentrations of credit.

One commenter felt that the potential risk of loss from concentrations of credit should be reflected in the allowance for loan and lease losses (ALLL). As described in the December 21, 1993 Interagency Policy Statement regarding the ALLL, the current amount of the loan and lease portfolio that is not likely to be collected should be reflected in the ALLL. In making a determination as to the appropriate level for the ALLL, the policy statement identifies concentrations of credit risk as one of several factors to be taken into account by an institution. While both the ALLL and capital serve as a cushion against losses, the difference between the ALLL and capital is that the ALLL should be maintained at a level that is adequate to absorb estimated losses, while capital is meant to provide an additional cushion for unexpected future losses. Because the magnitude and timing of losses from concentrations are hard to predict and therefore come unexpectedly, institutions with significant levels of concentrations of credit risk should hold capital above the regulatory minimums. At the same time, institutions with concentrations of credit that are experiencing a deterioration in credit quality and collectability should reflect the increased risk in those concentrations in the ALLL. Any identifiable loan and lease losses should be recognized immediately by reducing the asset's value and the ALLL.

C. Final Rules

After careful consideration of all the comments, the agencies have decided to adopt the proposed rules on concentration of credit risk without modification. The agencies believe that there is not currently an acceptable method to add a quantitative formula to the risk-based capital standards in order to measure concentration of credit risk. However, the agencies also believe that institutions identified through the examination process as having significant exposure to concentration of credit risk or as not adequately managing concentration risk, should hold capital in excess of the regulatory minimums.

The agencies have reached this conclusion for two reasons. First, although the agencies recognize that in some cases concentrations of credit are inevitable, they nonetheless can pose important risks. Other things being equal, an institution that is not diversified faces risks that a diversified institution does not, and accordingly presents risks to the deposit insurance fund that a diversified institution does not. Second, Congress in section 305 of FDICIA clearly mandated that these risks be taken into account in determining an institution's capital adequacy. OTS, however, does not believe it is appropriate to, and will not, implement section 305 in a way that penalizes thrift institutions for complying with the statutory Qualified Thrift Lender test. In addition, the agencies are not encouraging out-of-territory lending as a response to diversification concerns.

III. Risks of Nontraditional Activities

A. Proposed Approach

The agencies proposed to take account of the risks posed by nontraditional activities by ensuring that, as members of the industry began to engage in, or significantly expand their participation in, a nontraditional activity, the risks of that activity would be promptly analyzed and the activity given appropriate capital treatment. The agencies also proposed to amend their risk-based capital standards to explicitly cite the risks arising from nontraditional activities, and management's ability to monitor and control these risks, as important factors to consider in assessing an institution's overall capital adequacy.

New developments in technology and financial markets have introduced significant changes to the banking industry, and in some cases have led institutions to engage in activities not traditionally considered part of their business. Both in the risk-based capital regulations and guidelines adopted by the agencies in 1989 and in subsequent revisions and interpretations, the agencies have adopted measures to take adequate account of the risks of nontraditional activities under the risk-based capital standards. For example, the FRB, FDIC and the OCC have recently published for comment a proposal to change the way that the counterparty credit risks are measured and incorporated into a risk-based capital ratio for equity index, commodity, and precious metals off-balance sheet instruments. These

proposed changes were unique for each of the distinct products. The OTS intends to issue a parallel proposal in the near future. As nontraditional activities develop in the future, the agencies will address each activity on a case-by-case basis. Thus, to the extent that section 305 constitutes a mandate to the agencies to make certain that risk-based capital standards are kept current with industry practices, the agencies have been acting consistently with the intent of section 305.

B. Comments and Final Rules

While most comments focused on concentration of credit risk rather than nontraditional activities, some commenters noted their approval of the agencies' approach with regard to both parts of the rulemaking. Only a few commenters criticized the agencies' proposal on nontraditional activities, expressing concern that the agencies' proposals were too vague for examiners to apply or that the proposals were too inflexible.

After careful consideration of all the comments, the agencies are adopting the joint proposed rule on nontraditional activities without modification. The agencies believe that this final rule appropriately recognizes that the effect of a nontraditional activity on an institution's capital adequacy depends on the activity, the profile of the institution, and the institution's ability to monitor and control the risks arising from that activity. The agencies will continue their efforts to incorporate nontraditional activities into risk-based capital. In addition, to the extent appropriate, the agencies will issue examination guidelines on new developments in nontraditional activities or concentrations of credit to ensure that adequate account is taken of the risks of these activities.

IV. Paperwork Reduction Act

No collections of information pursuant to section 3504(h) of the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*) are contained in this final rule. Consequently, no information has been submitted to the Office of Management and Budget for review.

V. Regulatory Flexibility Act Statement

Each agency hereby certifies pursuant to section 605b of the Regulatory Flexibility Act (5 U.S.C. 605(b)) that the final rule will not have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). This final rule does not necessitate the development of sophisticated recordkeeping or reporting systems by small institutions; nor will small institutions need to seek out the expertise of specialized accountants, lawyers, or managers in order to comply with the regulation.

VI. Executive Order 12866

The OCC and OTS have determined that this final rule does not constitute "significant regulatory action" for purposes of Executive Order 12866.

List of Subjects

12 CFR Part 3

Administrative practice and procedure, Capital risk, National banks, Reporting and recordkeeping requirements.

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 325

Bank deposit insurance, Banks, Banking, Capital adequacy, Reporting and recordkeeping requirements, Savings associations, State nonmember banks.

12 CFR Part 567

Capital, Reporting and recordkeeping requirements, Savings associations.

Authority and Issuance

OFFICE OF THE COMPTROLLER OF THE CURRENCY

12 CFR Chapter I

For the reasons set out in the joint preamble, 12 CFR part 3 is amended as set forth below:

PART 3—MINIMUM CAPITAL RATIOS; ISSUANCE OF DIRECTIVES

1. The authority citation for part 3 is revised to read as follows:

Authority: 12 U.S.C. 93a, 161, 1818, 1828(n), 1828 note, 1831n note, 3907 and 3909.

2. Section 3.1 is revised to read as follows:

This part is issued under the authority of 12 U.S.C. 1 *et seq.*, 93a, 161, 1818, 3907 and 3909.

3. Section 3.10 is revised to read as follows:

§ 3.10 Applicability.

The OCC may require higher minimum capital ratios for an individual bank in view of its circumstances. For example, higher capital ratios may be appropriate for:

(a) A newly chartered bank;

(b) A bank receiving special supervisory attention;

(c) A bank that has, or is expected to have, losses resulting in capital inadequacy;

(d) A bank with significant exposure due to interest rate risk, the risks from concentrations of credit, certain risks arising from nontraditional activities, or management's overall inability to monitor and control financial and operating risks presented by concentrations of credit and nontraditional activities;

(e) A bank with significant exposure due to fiduciary or operational risk;

(f) A bank exposed to a high degree of asset depreciation, or a low level of liquid assets in relation to short-term liabilities;

(g) A bank exposed to a high volume of, or particularly severe, problem loans;

(h) A bank that is growing rapidly, either internally or through acquisitions; or

(i) A bank that may be adversely affected by the activities or condition of its holding company, affiliate(s), or other persons or institutions including chain banking organizations, with which it has significant business relationships.

Dated: November 18, 1994.

Eugene A. Ludwig,

Comptroller of the Currency.

FEDERAL RESERVE SYSTEM

12 CFR Chapter II

For the reasons set forth in the joint preamble, 12 CFR Part 208 is amended 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 continues 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 the fifth and sixth paragraphs under *"I. Overview"* to read as follows:

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

I. Overview

* * * * *

The risk-based capital ratio focuses principally on broad categories of credit risk although the framework for assigning assets and off-balance-sheet items to risk categories

does incorporate elements of transfer risk as well as limited instances of interest rate and market risk The framework incorporates risks arising from traditional banking activities as well as risks arising from nontraditional activities The risk-based ratio does not however incorporate other factors that can affect an institution's financial condition These factors include overall interest rate exposure, liquidity, funding and market risks, the quality and level of earnings, investment, loan portfolio, and other concentrations of credit risk, certain risks arising from nontraditional activities, the quality of loans and investments, the effectiveness of loan and investment policies, and management s overall ability to monitor and control financial and operating risks, including the risks presented by concentrations of credit and nontraditional activities

In addition to evaluating capital ratios, an overall assessment of capital adequacy must take account of those factors, including, in particular the level and severity of problem and classified assets For this reason, the final supervisory judgement on a bank's capital adequacy may differ significantly from conclusions that might be drawn solely from the level of its risk-based capital ratio.

* * * * *

By order of the Board of Governors of the Federal Reserve System, December 9, 1994

Barbara R. Lowrey,

Associate Secretary of the Board

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Chapter III

For the reasons set forth in the joint preamble, 12 CFR Part 325 is amended as follows.

PART 325—CAPITAL MAINTENANCE

1 The authority citation for part 325 is revised to read as follows·

Authority: 12 U S C 1815(a), 1815(b), 1816, 1818(a), 1818(b), 1818(c) 1818(t), 1819(Tenth), 1828(c), 1828(d), 1828(i), 1828(n), 1828(o), 1828 note, 1831n note, 1831o, 3907, 3909

§ 325.3 [Amended]

2 Section 325 3(a) is amended in the fourth sentence by adding "significant risks from concentrations of credit or nontraditional activities," immediately after "funding risks," and by adding "will take these other factors into account in analyzing the bank's capital adequacy and" immediately after "FDIC" and before "may"

3 The fifth paragraph of the introductory text of Appendix A to Part 325 is revised to read as follows

Appendix A to Part 325—Statement of Policy on Risk-Based Capital

* * * * *

The risk-based capital ratio focuses principally on broad categories of credit risk, however, the ratio does not take account of many other factors that can affect a bank's financial condition These factors include overall interest rate risk exposure, liquidity funding and market risks, the quality and level of earnings, investment loan portfolio, and other concentrations of credit risk, certain risks arising from nontraditional activities, the quality of loans and investments, the effectiveness of loan and investment policies, and management's overall ability to monitor and control financial and operating risks, including the risk presented by concentrations of credit and nontraditional activities. In addition to evaluating capital ratios, an overall assessment of capital adequacy must take account of each of these other factors, including, in particular, the level and severity of problem and adversely classified assets For this reason, the final supervisory judgment on a bank's capital adequacy may differ significantly from the conclusions that might be drawn solely from the absolute level of the bank's risk-based capital ratio.

* * * * *

By order of the Board of Directors.

Dated at Washington, DC, this 9th day of August 1994

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Acting Executive Secretary

OFFICE OF THRIFT SUPERVISION

12 CFR Chapter V

For the reasons set forth in the joint preamble, 12 CFR Part 567 is amended as follows:

SUBCHAPTER D—REGULATIONS APPLICABLE TO ALL SAVINGS ASSOCIATIONS

PART 567—CAPITAL

1. The authority citation for part 567 continues to read as follows:

Authority: 12 U.S C. 1462, 1462a, 1463, 1464, 1467a, 1828 (note).

2. Section 567.3 is amended by revising paragraphs (b)(3) and (b)(9) to read as follows:

§ 567.3 Individual minimum capital requirements.

* * * * *

(b) * * *

(3) A savings association that has a high degree of exposure to interest rate risk, prepayment risk, credit risk, concentration of credit risk, certain risks arising from nontraditional activities, or similar risks; or a high proportion of off-balance sheet risk, especially standby letters of credit;

* * * * *

(9) A savings association that has a record of operational losses that exceeds the average of other, similarly situated savings associations; has management deficiencies, including failure to adequately monitor and control financial and operating risks, particularly the risks presented by concentrations of credit and nontraditional activities, or has a poor record of supervisory compliance

* * * * *

Dated August 12, 1994

By the Office of Thrift Supervision

Jonathan L. Fiechter,

Acting Director

[FR Doc 94-30771 Filed 12-14-94, 8:45 am]

BILLING CODES: OCC 4810-33-P; Board 6210-01-P; FDIC 6714-01-P; OTS 6720-01-P