



FEDERAL RESERVE BANK  
OF DALLAS

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

DALLAS, TEXAS  
75265-5906

September 2, 1997

**Notice 97-75**

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

**SUBJECT**

**Request for Public Comment on Proposed  
Amendments to the Risk-Based Capital Guidelines**

**DETAILS**

The Board of Governors, along with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, is requesting public comment on a proposal to amend its risk-based and Tier 1 leverage capital guidelines for state member banks and bank holding companies. The proposed amendments address the treatment of servicing assets on both mortgage assets and financial assets other than mortgages.

Under the proposed rule, the amount of mortgage servicing assets includable in regulatory capital would be increased from 50 to 100 percent. In addition, all non-mortgage servicing assets would be fully deducted from Tier 1 capital.

The Board must receive comments by October 3, 1997. Please address comments 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-0976.

**ATTACHMENT**

A copy of the interagency notice as it appears on pages 42005-16, Vol. 62, No. 149 of the *Federal Register* dated August 4, 1997, is attached.

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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.

**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.*

# Registered Federal Reserve

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Monday  
August 4, 1997

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## Part III

### Department of the Treasury

Office of Comptroller of the Currency  
12 CFR Parts 3 and 6

### Federal Reserve System

12 CFR Parts 208 and 225

### Federal Deposit Insurance Corporation

12 CFR Part 325

### Department of the Treasury

Office of Thrift Supervision  
12 CFR Parts 565 and 567

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Capital; Risk-Based Capital Guidelines;  
Capital Adequacy Guidelines; Capital  
Maintenance: Servicing Assets; Proposed  
Rule

**DEPARTMENT OF THE TREASURY****Office of the Comptroller of the Currency****12 CFR Parts 3 and 6**

[Docket No. 97-15]

RIN 1557-AB14

**FEDERAL RESERVE SYSTEM****12 CFR Parts 208 and 225**

[Regulations H and Y; Docket No. R-0976]

**FEDERAL DEPOSIT INSURANCE CORPORATION****12 CFR Part 325**

RIN 3064-AC07

**DEPARTMENT OF THE TREASURY****Office of Thrift Supervision****12 CFR Parts 565 and 567**

[Docket No. 97-67]

RIN 1550-AB11

**Capital; Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Servicing Assets**

**AGENCIES:** Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and Office of Thrift Supervision, Treasury.

**ACTION:** Joint notice of proposed rulemaking.

**SUMMARY:** The Office of the Comptroller of the Currency, (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision, (OTS) (collectively, the Agencies) propose to amend their capital adequacy standards for banks, bank holding companies, and savings associations (banking organizations) to address the treatment of servicing assets on both mortgage assets and financial assets other than mortgages (non-mortgages). This proposed rule was developed in response to a recent Financial Accounting Standards Board (FASB) accounting standard that affects servicing assets; that is, Statement of Financial Accounting Standards No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" (FAS 125), issued in June 1996, which superseded Statement of Financial

Accounting Standards No. 122, "Accounting for Mortgage Servicing Rights" (FAS 122), issued in May 1995. Under this proposed rule, mortgage servicing assets included in regulatory capital would continue to be subject to certain prudential limitations. However, the limitation on the amount of mortgage servicing assets (and purchased credit card relationships) that can be recognized as a percent of Tier 1 capital would be increased from 50 to 100 percent. Also, all non-mortgage servicing assets would be fully deducted from Tier 1 capital. The Agencies are requesting comment on the regulatory capital limitations that are being proposed for servicing assets and on whether any interest-only strips receivable should be subject to the same regulatory capital limitations as servicing assets.

**DATES:** Comments must be received on or before October 3, 1997.

**ADDRESSES:** Interested parties are invited to submit written comments to any or all of the Agencies. All comments will be shared among the Agencies.

**OCC:** Written comments should be submitted to Docket No. 97-15, Communications Division, Ninth Floor, Office of the Comptroller of the Currency, 250 E Street, SW., Washington, DC 20219. Comments will be available for inspection and photocopying at that address. In addition, comments may be sent by facsimile transmission to FAX number (202) 874-5274, or by electronic mail to [regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov).

**Board:** Comments should refer to Docket No. R-0976, and may be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551. Comments also may be delivered to the Board's mail room between 8:45 a.m. and 5:15 p.m. weekdays, and to the security control room at all other times. The mail room and the security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, NW. Comments received will be available for inspection in Room MP-500 of the Martin Building between 9:00 a.m. and 5:00 p.m. weekdays, except as provided in 12 CFR 261.8 of the Board's Rules Regarding Availability of Information.

**FDIC:** Written comments shall be addressed to Robert E. Feldman, Executive Secretary, Attention: Comments/OES, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429. Comments may be hand delivered to the guard station at the rear of the 17th Street

Building (located on F Street), on business days between 7:00 a.m. and 5:00 p.m. (Fax number: (202) 898-3838; Internet address: [comments@fdic.gov](mailto:comments@fdic.gov)). Comments may be inspected and photocopied in the FDIC Public Information Center, Room 100, 801 17th Street, NW., Washington, DC, between 9:00 a.m. and 4:30 p.m. on business days.

**OTS:** Send comments to Chief, Dissemination Branch, Records Management and Information Policy, Office of Thrift Supervision, 1700 G Street, NW., Washington, D.C. 20552, Attention Docket No. 97-67. These submissions may be hand-delivered to 1700 G Street, N.W. between 9 a.m. and 5 p.m. on business days; they may be sent by facsimile transmission to FAX Number (202) 906-7755; or by e-mail to [public.info@ots.treas.gov](mailto:public.info@ots.treas.gov). Those commenting by e-mail should include their name and telephone number. Comments will be available for inspection at 1700 G Street, N.W., from 9:00 a.m. until 4:00 p.m. on business days.

**FOR FURTHER INFORMATION CONTACT:**

**OCC:** Gene Green, Deputy Chief Accountant (202/874-5180); Roger Tufts, Senior Economic Adviser, or Tom Rollo, National Bank Examiner, Capital Policy Division (202/874-5070); Mitchell Stengel, Senior Financial Economist, Risk Analysis Division (202/874-5431); Saumya Bhavsar, Attorney or Ronald Shimabukuro, Senior Attorney (202/874-5090), Legislative and Regulatory Activities Division, Office of the Comptroller of the Currency.

**Board:** Arleen Lustig, Supervisory Financial Analyst (202/452-2987), Arthur W. Lindo, Supervisory Financial Analyst, (202/452-2695) or Thomas R. Boemio, Senior Supervisory Financial Analyst, (202/452-2982), Division of Banking Supervision and Regulation. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Diane Jenkins (202) 452-3544, Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC 20551.

**FDIC:** For supervisory issues, Stephen G. Pfeifer, Examination Specialist, (202/898-8904), Accounting Section, Division of Supervision; for legal issues, Marc J. Goldstom, Counsel, (202/898-8807), Legal Division.

**OTS:** John F. Connolly, Senior Program Manager for Capital Policy, Supervision Policy Division (202/906-6465), Christine Smith, Capital and Accounting Policy Analyst, (202/906-5740), Timothy J. Stier, Chief Accountant, (202/906-5699),

Accounting Policy Division, or Vern McKinley, Attorney, Regulations and Legislation Division (202/906-6241), Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

#### SUPPLEMENTARY INFORMATION:

##### Background

##### *Capital Treatment of Mortgage Servicing Rights Pre-FAS 122*

Prior to the issuance of FAS 122, intangible assets generally were deducted from capital in determining the amount of Tier 1 capital under the Agencies' regulatory capital rules.<sup>1</sup> However, limited amounts of purchased mortgage servicing rights (PMSRs) and purchased credit card relationships (PCCRs) were allowed in Tier 1 capital.<sup>2</sup> The aggregate amount of PMSRs and PCCRs that could be recognized for regulatory capital purposes could not exceed 50 percent of Tier 1 capital, with PCCRs subject to a further sublimit of 25 percent of Tier 1 capital. In addition, PMSRs and PCCRs were each subject to a 10 percent "haircut" that permitted only the lower of book value or 90 percent of fair market value to be included in Tier 1 capital. This haircut is required for PMSRs under section 475 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. 1828 note) (December 19, 1991)).

The regulatory capital treatment of servicing rights prior to the issuance of FAS 122 specified a treatment for PMSRs but not for originated mortgage servicing rights (OMSRs) or servicing rights on loans other than mortgages because generally accepted accounting principles (GAAP), at that time, did not permit institutions to book OMSRs nor did it generally allow institutions to book servicing rights on other assets. Furthermore, GAAP based the accounting for servicing rights on a distinction between normal servicing fees and excess servicing fees.<sup>3</sup>

Although GAAP permitted excess servicing fees receivable (ESFRs) to be recognized as assets, for regulatory reporting purposes, banks generally were allowed to book only ESFRs on first lien, one-to four-family residential mortgages. The Agencies did not allow banks to book ESFRs on any other loans and, thus, these ESFRs were also effectively excluded from capital for regulatory reporting and regulatory capital purposes.<sup>4</sup>

##### *FAS 122 and the Interim Rule*

In May 1995, FASB issued FAS 122, which eliminated the GAAP distinction between OMSRs and PMSRs and required that these assets, together known as mortgage servicing rights (MSRs), be treated as a single asset for financial statement purposes, regardless of how the servicing rights were acquired. Under FAS 122, OMSRs and PMSRs are treated the same for reporting, valuation, and disclosure purposes.<sup>5</sup> The GAAP accounting treatment of ESFRs was not changed by FAS 122.

The Agencies adopted the FAS 122 standard for regulatory reporting purposes and then issued an interim rule on the regulatory capital treatment of MSRs (60 FR 39226, August 1, 1995), with a request for public comment. The interim rule, which became effective upon publication, amended the Agencies' capital adequacy standards to treat OMSRs in the same manner as PMSRs for regulatory capital purposes. Under the interim rule, the total of all MSRs (i.e., PMSRs and OMSRs), when combined with PCCRs, that can be included in regulatory capital cannot exceed 50 percent of Tier 1 capital. In addition, the interim rule extended the 10 percent haircut to all MSRs. The interim rule did not amend any other elements of the Agencies' capital rules.<sup>6</sup>

organization sold loans but retained the servicing and received a servicing fee that was in excess of a normal servicing fee. Excess servicing fees receivable were the present value of the excess servicing fees and were reported on the institution's balance sheet. GAAP continued to differentiate between normal and excess servicing fees until FAS 125 was implemented in January 1997.

<sup>4</sup> Bank holding companies and thrift institutions, however, were allowed to report ESFRs for regulatory reporting purposes and recognize all ESFRs in capital in accordance with existing GAAP.

<sup>5</sup> Among other things, FAS 122 imposed valuation and impairment criteria, based on the stratification of MSRs by their predominant risk characteristics. In addition, FAS 122 eliminated the intangible asset reference that prior GAAP applied to MSRs and stated that the characterization of MSRs as either intangible or tangible was unnecessary because similar characterizations are not applied to most other assets.

<sup>6</sup> Thus, PCCRs continued to be subject to the 25 percent of Tier 1 capital sublimit.

A majority of the commenters opposed the interim rule's capital limitations. Several commenters stated that the capital limitations ignored the increased marketability of MSRs, while others asserted that FAS 122's valuation and impairment requirements for MSRs were conservative, thereby providing safeguards against the risks associated with these assets. They believed that FAS 122's stringent valuation and impairment standards (lower of cost or market [LOCOM] on a stratum-by-stratum basis) precluded the need for arbitrary regulatory capital limits. In addition, while acknowledging that the 10 percent haircut is required by statute for PMSRs, commenters advocated a legislative change to eliminate it. If capital limitations on MSRs are retained, most commenters agreed that disallowed MSRs, i.e., those that exceeded 50 percent of Tier 1 capital, should be deducted from Tier 1 capital on a basis that is net of any associated deferred tax liability.

##### *FAS 125*

In June 1996, FASB issued FAS 125, which became effective for all transfers and servicing of financial assets on or after January 1, 1997. FAS 125 requires the recording of servicing on all financial assets that are serviced for others, including loans other than mortgages.<sup>7</sup>

FAS 125 eliminates the distinction between normal servicing fees and excess servicing fees and reclassifies these cash flows into two new types of assets: (a) Servicing assets, which are measured based on contractually specified servicing fees; and (b) interest-only (I/O) strips receivable, which reflect rights to future interest income from the serviced assets in excess of the contractually specified servicing fees. In addition, FAS 125 requires I/O strips and other financial assets that can be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment (including loans, other receivables, and retained interests in securitizations) to be measured at fair value like debt securities that are classified as available-for-sale or trading securities under FASB Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities" (FAS 115).

<sup>7</sup> In a press release issued on December 18, 1996, the Federal Financial Institutions Examination Council (FFIEC) issued interim guidance for the regulatory capital treatment of servicing assets under the Agencies' existing capital standards, which, after the effective date of FAS 125, will remain in effect until the Agencies issue a final rule on servicing assets.

<sup>1</sup> For OTS purposes, Tier 1 capital is the same as core capital.

<sup>2</sup> Servicing rights are the contractual obligations undertaken by an institution to provide servicing for loans owned by others, typically for a fee. PMSRs are mortgage servicing rights that have been purchased from other parties. The purchaser is not the originator of the mortgage. Originated mortgage servicing rights, on the other hand, generally represent the servicing rights acquired when an institution originates mortgage loans and subsequently sells the loans but retains the servicing rights. Under the accounting standards that were in effect prior to FAS 122, mortgage servicing rights were characterized as intangible assets.

<sup>3</sup> A normal servicing fee was defined as a servicing fee that was representative of servicing fees most commonly used in comparable servicing agreements covering similar types of loans. Excess servicing fees arose only when a banking



Under FAS 125, organizations are required to recognize separate servicing assets (or liabilities) for the contractual obligation to service financial assets (e.g., mortgage loans, credit card receivables) that the entity has either sold or securitized with servicing retained. In addition, servicing assets (or liabilities) that are purchased (or assumed) as part of a separate transaction must also be recognized. However, no servicing asset (or liability) need be recognized when an organization securitizes assets, retains all of the resulting securities, and classifies the securities as held-to-maturity in accordance with FAS 115.

Under FAS 125, the existence of a servicing asset (or liability) is based on revenues a servicer would receive for performing the servicing. A servicing asset is recorded for a contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges, and other ancillary revenues (such as "float") are expected to more than adequately compensate the servicer for performing the servicing.<sup>8</sup> However, amounts representing rights to future interest income from serviced assets in excess of contractually specified servicing fees are not treated as servicing assets under FAS 125 since the right to this excess future interest income does not depend on the servicing work being satisfactorily performed and remaining with the servicer. Rather, these amounts are treated as financial assets, effectively, I/O strips receivable.

FAS 125 also adopts the valuation approach established by FAS 122 for determining the impairment of mortgage servicing assets (MSAs) and extends this approach to all other servicing assets, i.e., servicing assets on financial assets other than mortgages.

### Proposed Amendments to the Capital Adequacy Standards

#### Overview

The Agencies are proposing to increase the amount of MSAs that can be recognized for regulatory capital purposes.<sup>9</sup> However, under this

<sup>8</sup> FAS 125 defines contractually specified servicing fees as all amounts that, per contract, are due to the servicer in exchange for servicing a financial asset and would no longer be received by a servicer if the beneficial owners of the serviced assets or their trustees or agents were to shift the servicing to another servicer.

<sup>9</sup> For regulatory capital purposes, a mortgage servicing asset is a servicing asset that results from a contract to service mortgages (as defined in the Reports of Condition and Income for commercial banks and FDIC-supervised savings banks, Thrift Financial Report (TFR) for savings associations, and

proposal, servicing assets on financial assets other than mortgages would continue to be deducted from Tier 1 capital. The Agencies are also seeking comment on whether I/O strips receivable that are not in the form of a security (whether held by the servicer or purchased from another organization) should be subject to the capital limitations imposed on servicing assets.

In this proposal, consistent with the interim capital guidance announced by the FFIEC in its December 1996 press release, the Agencies have chosen to use FAS 125 terminology when referring to servicing assets and financial assets in the belief that the adoption of the same terms for regulatory purposes would reduce the burden of having to maintain two sets of definitions—one for capital purposes and another for financial reporting purposes.<sup>10</sup>

#### Capital Limitation for Mortgage Servicing Assets

This proposal would subject all MSAs to a 100 percent of Tier 1 capital limitation and to a 10 percent of fair value haircut.<sup>11</sup> The 10 percent haircut applied to all MSAs imposes some safeguards on the amount of MSAs that can be included in Tier 1 capital calculations and, notwithstanding the valuation and impairment standards in FAS 122 and FAS 125, provides a greater level of supervisory comfort that addresses concerns about the risks (e.g., these assets are potentially volatile due to interest rate and prepayment risk) involved in holding these assets.<sup>12</sup>

The Agencies propose to retain a capital limitation on MSAs based on a percentage of Tier 1 capital to minimize banking organizations' reliance on these MSAs as part of the organizations' regulatory capital base. Excessive concentrations in these assets could potentially have an adverse impact on bank capital. The Agencies, however,

Consolidated Financial Statements (FR Y-9C) for bank holding companies).

<sup>10</sup> The Agencies' regulatory reports (Reports of Condition and Income for commercial banks and FDIC-supervised savings banks, Thrift Financial Report (TFR) for savings associations, and Consolidated Financial Statements (FR Y-9C) for bank holding companies) also reflect FAS 125 definitions for the reporting of servicing assets beginning with the first quarter of 1997.

<sup>11</sup> PCCRs would also continue to be subject to the 10 percent of fair value haircut.

<sup>12</sup> For purposes of determining the amount of servicing assets on financial assets (mortgage loans and other financial assets) that would be deducted (or disallowed) under this proposal, organizations may choose to reduce their otherwise disallowed servicing assets by the amount of any associated deferred tax liability. Any deferred tax liability used in this manner would not be available for the organization to use in determining the amount of net deferred tax assets that may be included for purposes of Tier 1 capital calculations.

propose to increase the capital limitation so that the amount of MSAs, when combined with PCCRs, that can be included in capital can equal no more than 100 percent of Tier 1 capital. The Agencies believe that a higher limit is more reasonable in light of the more specific accounting guidance in FAS 125 for the valuation and impairment of servicing assets. Moreover, the Agencies believe that some banking organizations will exceed the current 50 percent of Tier 1 capital limitation due only to changes in the accounting for servicing contracts brought about by FAS 122 and FAS 125.

#### Capital Treatment of Servicing Assets on Financial Assets Other Than Mortgages (Non-Mortgage Servicing Assets)

The Agencies propose to deduct from Tier 1 capital all non-mortgage servicing assets.<sup>13</sup> Although the Agencies recognize that the markets for servicing assets for some types of financial assets other than mortgages are growing, these markets are not as developed as the mortgage servicing market. Therefore, the Agencies propose to fully deduct non-mortgage servicing assets from capital because of concerns that the markets for these assets may not yet be of sufficient depth to provide liquidity for these assets. In addition, the Agencies are uncertain whether the fair values of these servicing assets can be determined with a high degree of reliability and predictability. Therefore, at this time, the Agencies propose to exclude these assets from Tier 1 capital.<sup>14</sup>

#### Summary of Proposed Capital Amendment

The Agencies are proposing two alternatives (alternative A and alternative B), which are described below, to revise their capital adequacy standards for servicing assets. These alternatives provide different treatments of I/O strips receivable. Moreover, the proposed alternatives do not reflect all deductions (e.g., the disallowed amount of deferred tax assets and net unrealized losses on available-for-sale equity

<sup>13</sup> Originated servicing rights on financial assets other than mortgages were not booked as balance sheet assets under pre-FAS 125 GAAP. However, for regulatory reporting purposes, banks prior to 1997 were permitted to indirectly recognize ESFRs on certain government-guaranteed small business loans, and thrifts and bank holding companies booked ESFRs on financial assets other than mortgages in accordance with GAAP. Under FAS 125, these ESFRs have been reclassified as either servicing assets or I/O strips receivable, depending on whether the assets are part of the "contractually specified servicing fee," as that term is defined in FAS 125.

<sup>14</sup> See footnote 12.

securities with readily determinable fair values) that are required when organizations calculate their Tier 1 capital ratios. The regulatory capital limitations under this proposal can be summarized as follows:

(a) Servicing assets and PCCRs that are includable in capital are each subject to a 90 percent of fair value limitation (also known as a "10 percent haircut").<sup>15</sup>

(b) MSAs and PCCRs must be less than or equal to 100% of Tier 1 capital.<sup>16</sup>

(c) PCCRs must be less than or equal to 25% of Tier 1 capital.

(d) Non-mortgage servicing assets and all intangible assets (other than qualifying PCCRs) must be deducted from Tier 1 capital.

Under alternative A, I/O strips (whether or not in the form of securities) would not be subject to any regulatory capital limit. Under alternative B, I/O strips receivable not in security form (whether held by the servicer or purchased from another organization) would be subject to the same capital limitation that is applied to the corresponding type of servicing assets. That is, if the I/O strips receivable are related to mortgages, they would be combined with MSAs and the combined amount would be subject to the 100 percent of Tier 1 capital limitation; if the I/O strips are related to financial assets other than mortgages, they would be deducted from Tier 1 capital.<sup>17</sup> Furthermore, the I/O strips receivable subject to the Tier 1 capital limitation would also be subject to the 10 percent haircut. In all other respects, alternatives A and B are identical. The proposed rules attached to this document reflect alternative A.

The Agencies are requesting public comment on whether to adopt alternative A or B for regulatory capital purposes. The Agencies also are seeking comment on whether to extend the capital limitation imposed on servicing assets (mortgage and non-mortgage) to

include certain other non-security financial instruments, such as loans, other receivables, or other retained interests in securitizations, that can be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment.

Some reasons in support of amending the capital adequacy standards to reflect alternative A, which would not subject I/O strips receivable to a Tier 1 capital limitation, are:

(1) I/O strips receivable not in security form are similar in economic substance to I/O strip securities. These I/O strips receivable should be treated in a manner consistent with the manner in which the Agencies treat I/O strip securities and not be subject to capital limitations.<sup>18</sup> Moreover, because there is insufficient data on these new financial assets, the Agencies should not, at this time, impose capital limits on these new financial assets. Rather, the Agencies should let the market develop before assessing whether any regulatory limitations are warranted.

(2) Certain I/O strips receivable on credit card receivables would likely be subject to a risk-based capital charge under the recourse rules established by the Agencies because these I/O strips receivable, which generally act as credit enhancements for the credit card asset-backed securities sold, would function as recourse. Thus, the risk-based capital rules for "assets sold with recourse" would apply to these I/O strips receivable.

(3) Under FAS 125, the cash flows underlying the I/O strips receivable not in security form actually possess characteristics that are more similar to I/O strip securities than to ESFRs because the holder of a non-security I/O strip receivable retains the rights to the I/O strip cash flows *even if* the underlying servicing (and the related servicing asset) is shifted away from the servicer (if, for example, the servicer fails to perform in accordance with the servicing contract). Thus, I/O strips receivable not in security form should be treated similarly to I/O strip securities, which are not subject to regulatory capital limitations.

(4) The amount of I/O strips receivable recognized by banking organizations may be limited. For example, the discipline imposed by the

well-developed mortgage markets may minimize the amounts retained by the servicers above the contractually specified servicing fee amount.

Some reasons in support of amending the capital adequacy standards to reflect alternative B, which limits the amount of I/O strips receivable not in security form that can be included in Tier 1 capital, are:

(1) I/O strips receivable not in security form are not rated and are not registered. Rather, they are relatively new financial assets, which are recognized on the balance sheet in response to the recently issued FAS 125, and for which an active, liquid market does not currently exist. In contrast, I/O strips receivable that are registered securities have an identifiable market and are readily salable. Since the market for these newly-created I/O strips receivable is not currently well-developed, accurate, dependable information on the fair value of such assets may not be readily available or may be difficult to ascertain.

(2) I/O strips receivable not in security form arising from servicing activities should receive a no less restrictive capital treatment than the treatment afforded to the servicing asset itself because servicing assets and the I/O strips receivable both arise from the same activity and are subject to similar prepayment risk.

(3) If I/O strips receivable retained by the servicer are not subject to the same capital limitation as their related servicing assets, banking organizations may be inclined to avoid capital limitations by negotiating contracts that minimize contractually specified servicing fees, thereby enabling them to classify more of the cash flows as I/O strips receivable. This would understate the servicing assets and, thus, minimize the effectiveness of any capital limitation.

(4) The economic substance of servicing transactions remains unchanged. Under FAS 125, the cash flows of these transactions have simply been reclassified into new assets such as I/O strips receivable. The risks associated with the servicing assets and the I/O strips receivable have not changed.

### Tangible Equity

The definition of tangible equity found in each Agency's regulation for Prompt Corrective Action would be revised to conform to the changes made in the proposed rule, i.e., the term "mortgage servicing rights" would be renamed "mortgage servicing assets" to reflect the FAS 125 conceptual changes for measuring servicing. No other

<sup>15</sup> If some or all types of non-mortgage servicing assets are includable in capital in the final rule, they would most likely be subject to the 90 percent of fair value limitation.

<sup>16</sup> Amounts of MSAs and PCCRs in excess of the amounts allowable must be deducted from Tier 1 capital.

<sup>17</sup> Under either alternative A or B, I/O strips that take the form of mortgage-backed securities are subject to the provisions of the Agencies' Supervisory Policy Statement on Securities Activities (57 FR 4029, February 3, 1992). They are not, however, subject to any Tier 1 capital limitations. I/O strips receivable that arise in sales and securitizations of assets, which use this receivable as a credit enhancement, are considered asset sales with recourse under the Agencies' risk-based capital standards. Such I/O strips would be treated like other recourse obligations under the Agencies' capital rules and would not be subject to the capital limitations for servicing assets.

<sup>18</sup> I/O strips from mortgage-backed securities that are currently held by banks and thrifts are subject to the "high-risk test" in the Agencies' Supervisory Policy Statement on Securities Activities (57 FR 4029, February 3, 1992). That policy statement has, in the past, limited a depository institution's ability to hold I/Os because they typically are "high-risk" mortgage securities.



changes to the definition of tangible equity are proposed at this time.<sup>19</sup>

#### Request for Public Comment

The Agencies invite comments on all aspects of these proposed changes. In particular, the Agencies seek comments from interested parties on the following:

1. How readily determinable are fair values of mortgage servicing assets and non-mortgage servicing assets (e.g., credit card servicing assets)? Please describe the existing methodologies and market mechanisms used by your organization for determining fair values for servicing assets.

2. Given the supervisory concerns regarding the reliability of the valuation of servicing assets and the potential volatility in the fair value of these assets, should limits be retained on the amount of servicing assets that is recognized for regulatory capital purposes?

a. What aggregate limit, if any, should apply to the maximum amount of mortgage servicing assets and PCCRs that may be recognized for regulatory capital purposes?

b. To what extent should servicing assets on non-mortgage financial assets be included in regulatory capital?

c. Should non-mortgage servicing assets and I/O strips receivable (if treated similarly to non-mortgage servicing assets) be subject to the same 25 percent sublimit and haircut as PCCRs?

3. What types of assets should be subject to regulatory capital limitations under this rule?

a. Should I/O strips receivable not in security form be subject to the same capital limitations as servicing assets?

b. If alternative B is adopted, should the definition of I/O strips receivable that are subject to capital limitations be expanded to include all financial assets not in security form that can be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment as described under FAS 125? These assets would include loans, other receivables, and other retained interests in securitizations that meet this condition. Please provide supporting information on the nature of these non-security financial assets with significant prepayment risk.

4. For what types of financial assets (other than loans secured by first liens on 1- to 4-family residential properties) does your organization currently book

servicing assets and/or I/O strips receivable? How will this change in the future for your organization?

5. In light of FAS 125 and this proposal, what should be the capital treatment for amounts previously designated as ESRs for financial reporting purposes (if your organization still maintains this breakdown for income tax or other purposes) held by banking organizations?

6. What effect, if any, should efforts to hedge the MSA portfolio have on the MSA regulatory capital limitations?

7. Should servicing assets that are disallowed for regulatory capital purposes be deducted on a basis that is net of any associated deferred tax liability?

#### Regulatory Flexibility Act Analysis

##### OCC Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act, the Comptroller of the Currency certifies that this proposed rule would not have a significant economic impact on a substantial number of small entities in accord with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). Accordingly, a regulatory flexibility analysis is not required. The adoption of this proposal would reduce the regulatory burden of small businesses by aligning the terminology in the capital adequacy standards more closely to newly-issued generally accepted accounting principles and by relaxing the capital limitation on mortgage servicing assets. The economic impact of this proposed rule on banks, regardless of size, is expected to be minimal.

##### Board Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act, the Board does not believe that this proposed rule would have a significant economic impact on a substantial number of small entities in accord with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). Accordingly, a regulatory flexibility analysis is not required. The effect of this proposal would be to reduce the regulatory burden of banks and bank holding companies by aligning the terminology in the capital adequacy guidelines more closely to newly-issued generally accepted accounting principles and by relaxing the capital limitation on mortgage servicing assets. 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.

##### FDIC Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act (Pub. L. 96-354, 5 U.S.C. 601 *et seq.*), it is certified that this proposed rule would not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. The amendment concerns capital requirements for servicing assets held by depository institutions of any size. The effect of the proposal would be to reduce regulatory burden on depository institutions (including small businesses) by aligning the terminology used in the capital adequacy guidelines more closely to newly-issued generally accepted accounting principles and by relaxing the capital limitation on mortgage servicing assets. The economic impact of this proposed rule on banks, regardless of size, is expected to be minimal.

##### OTS Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act, the OTS certifies that this proposed rule would not have a significant economic impact on a substantial number of small entities. The amendment concerns capital requirements for servicing assets which may be entered into by depository institutions of any size. The effect of the proposal would be to reduce regulatory burden on depository institutions by aligning the terminology used in the capital adequacy standards more closely to newly-issued generally accepted accounting principles and by relaxing the capital limitation on mortgage servicing assets.

#### Paperwork Reduction Act

The Agencies have determined that this proposal would not increase the regulatory paperwork of banking organizations pursuant to the provisions of the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*).

#### OCC and OTS Executive Order 12866 Statement

The Comptroller of the Currency and the Director of the OTS have determined that this proposal is not a significant regulatory action under Executive Order 12866. Accordingly, a regulatory impact analysis is not required.

#### OCC and OTS Unfunded Mandates Act Statement

Section 202 of the Unfunded Mandates Reform Act of 1995, Pub. L. 104-4 (Unfunded Mandates Act)

<sup>19</sup> The OTS is proposing to make an additional technical clarification to its definition of tangible equity in 12 CFR 565.2(f) that would conform the OTS rule to this proposal and eliminate the double deduction of disallowed mortgage servicing assets.



requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in expenditure by State, local and tribal governments, in the aggregate, or by the private sector, of \$100 million or more in any one year. If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. As discussed in the preamble, this proposed amendment to the capital adequacy standards would relax the capital limitation on mortgage servicing assets and PCCRs. Further, the proposed amendment moves toward greater consistency with FAS 125 in an effort to reduce the burden of complying with two different standards. Thus, no additional cost of \$100 million or more, to State, local, or tribal governments or to the private sector will result from this proposed rule. Accordingly, the OCC and the OTS have not prepared a budgetary impact statement nor specifically addressed any regulatory alternatives.

#### List of Subjects

##### 12 CFR Part 3

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

##### 12 CFR Part 6

National banks, Prompt corrective action.

##### 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.

##### 12 CFR Part 325

Administrative practice and procedure, Banks, banking, Capital adequacy, Reporting and recordkeeping requirements, Savings associations, State non-member banks.

##### 12 CFR Part 565

Administrative practice and procedure, Capital, Savings associations.

##### 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 forth in the joint preamble, parts 3 and 6 of chapter I of title 12 of the Code of Federal Regulations are proposed to be amended as follows:

#### PART 3—MINIMUM CAPITAL RATIOS; ISSUANCE OF DIRECTIVES

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

**Authority:** 12 U.S.C. 93a, 161, 1818, 1828(n), 1828 note, 1831n note, 1835, 3907, and 3909.

##### § 3.3 [Amended]

2. Section 3.3 is amended by removing the words "mortgage servicing rights" in the first sentence and adding "mortgage servicing assets" in their place.

3. Section 3.100 is amended by revising paragraph (c)(2) and by removing the words "mortgage servicing rights" in paragraphs (e)(7) and (g)(2) and adding "mortgage servicing assets" in their place, to read as follows:

##### § 3.100 Capital and surplus.

\* \* \* \* \*

(c) \* \* \*

(2) Mortgage servicing assets;

\* \* \* \* \*

4. In appendix A to part 3, paragraph (c)(14) of section 1 is revised to read as follows:

#### Appendix A to Part 3—Risk-Based Capital Guidelines

*Section 1. Purpose, Applicability of Guidelines, and Definitions.*

\* \* \* \* \*

(c) \* \* \*

(14) *Intangible assets* include mortgage servicing assets, purchased credit card relationships (servicing rights), goodwill, favorable leaseholds, and core deposit value.

\* \* \* \* \*

5. In appendix A to part 3, in section 2, paragraphs (c) introductory text, (c)(1), (c)(2), and the heading of paragraph (c)(3)(i) are revised to read as follows:

\* \* \* \* \*

Section 2. Components of Capital.

\* \* \* \* \*

(c) *Deductions From Capital.* The following items are deducted from the appropriate portion of a national bank's capital base when calculating its risk-based capital ratio.

(1) *Deductions from Tier 1 capital.* The following items are deducted from Tier 1 capital before the Tier 2 portion of the calculation is made:

(i) All goodwill subject to the transition rules contained in section 4(a)(1)(ii) of this appendix A;

(ii) Non-mortgage servicing assets;

(iii) Other intangible assets, except as provided in section 2(c)(2) of this appendix A; and

(iv) Deferred tax assets, except as provided in section 2(c)(3) of this appendix A, that are dependent upon future taxable income, which exceed the lesser of either:

(A) The amount of deferred tax assets that the bank could reasonably expect to realize within one year of the quarter-end Call Report, based on its estimate of future taxable income for that year; or

(B) 10% of Tier 1 capital, net of goodwill and all intangible assets other than mortgage servicing assets and purchased credit card relationships, and before any disallowed deferred tax assets are deducted.

(2) *Qualifying intangible assets.* Subject to the following conditions, mortgage servicing assets and purchased credit card relationships need not be deducted from Tier 1 capital:

(i) The total of all intangible assets included in Tier 1 capital is limited to 100 percent of Tier 1 capital, of which no more than 25 percent of Tier 1 capital can consist of purchased credit card relationships. Calculation of these limitations must be based on Tier 1 capital net of goodwill and other disallowed intangible assets.

(ii) Banks must value each intangible asset included in Tier 1 capital at least quarterly at the lesser of:

(A) 90 percent of the fair value of each asset, determined in accordance with paragraph (c)(2)(iii) of this section; or

(B) 100 percent of the remaining unamortized book value.

(iii) The quarterly determination of the current fair value of the intangible asset must include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates.

(3) *Deferred tax assets*—(i) *Net unrealized gains and losses on available-for-sale securities.* \* \* \*

\* \* \* \* \*

#### PART 6—PROMPT CORRECTIVE ACTION

1. The authority citation for part 6 continues to read as follows:

**Authority:** 12 U.S.C. 93a, 1831o.

2. Section 6.2(g) is revised to read as follows:

##### § 6.2 Definitions

\* \* \* \* \*

(g) *Tangible equity* means the amount of Tier 1 capital elements in the OCC's Risk-Based Capital Guidelines (12 CFR part 3, appendix A) plus the amount of outstanding cumulative perpetual preferred stock (including related surplus) minus all intangible assets

except mortgage servicing assets to the extent permitted in Tier 1 capital under 12 CFR part 3, appendix A, section 2(c)(2).

\* \* \* \* \*

Dated: July 17, 1997.

Eugene A. Ludwig,  
Comptroller of the Currency.

## Federal Reserve System

### 12 CFR CHAPTER II

For the reasons set forth in the joint preamble, the Board of Governors of the Federal Reserve System proposes to amend parts 208 and 225 of chapter II of title 12 of the Code of Federal Regulations 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), 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), 78o–5, 78q, 78q–1, and 78w; 31 U.S.C. 5318; 42 U.S.C. 4012a, 4104a, 4104b, 4106, and 4128.

2. Section 208.41, as proposed to be renumbered from § 208.31 and revised at 62 FR 15291, is further amended by revising paragraph (f) to read as follows:

### § 208.41 Definitions for purposes of this subpart.

\* \* \* \* \*

(f) *Tangible equity* means the amount of core capital elements as defined in the Board's Capital Adequacy Guidelines for State Member Banks: Risk-Based Measure (Appendix A to this part), plus the amount of outstanding cumulative perpetual preferred stock (including related surplus), minus all intangible assets except mortgage servicing assets to the extent that the Board determines that mortgage servicing assets may be included in calculating the bank's Tier 1 capital.

\* \* \* \* \*

3. In Appendix A to part 208, sections II.B.1.b.i. through II.B.1.b.v. are revised to read as follows:

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

\* \* \* \* \*

### II. \*\*\*

#### B. \*\*\*

##### 1. *Goodwill and other intangible assets* \*\*\*

b. *Other intangible assets.* i. All servicing assets, including servicing assets on assets other than mortgages (i.e., non-mortgage servicing assets) are included in this Appendix A as identifiable intangible assets.

The only types of identifiable intangible assets that may be included in, that is, not deducted from, a bank's capital are readily marketable mortgage servicing assets and purchased credit card relationships. The total amount of these assets included in capital, in the aggregate, can not exceed 100 percent of Tier 1 capital. Purchased credit card relationships are subject to a separate sublimit of 25 percent of Tier 1 capital.<sup>14</sup>

ii. For purposes of calculating these limitations on mortgage servicing assets and purchased credit card relationships, Tier 1 capital is defined as the sum of core capital elements, net of goodwill, and net of all identifiable intangible assets other than mortgage servicing assets and purchased credit card relationships, regardless of the date acquired, but prior to the deduction of deferred tax assets.

iii. Banks must review the book value of all intangible assets at least quarterly and make adjustments to these values as necessary. The fair value of mortgage servicing assets and purchased credit card relationships also must be determined at least quarterly. This determination shall include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates or account attrition rates.

iv. Examiners will review both the book value and the fair value assigned to these assets, together with supporting documentation, during the examination process. In addition, the Federal Reserve may require, on a case-by-case basis, an independent valuation of a bank's intangible assets.

v. The amount of mortgage servicing assets and purchased credit card relationships that a bank may include in capital shall be the lesser of 90 percent of their fair value, as determined in accordance with this section, or 100 percent of their book value, as adjusted for capital purposes in accordance with the instructions in the commercial bank Consolidated Reports of Condition and Income (Call Reports). If both the application of the limits on mortgage servicing assets and purchased credit card relationships and the adjustment of the balance sheet amount for these assets 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.

\* \* \* \* \*

4. In Appendix A to part 208, section II.B.4. is revised to read as follows:

\* \* \* \* \*

### II. \*\*\*

<sup>14</sup> Amounts of mortgage servicing assets and purchased credit card relationships in excess of these limitations, as well as identifiable intangible assets, including core deposit intangibles, favorable leaseholds and non-mortgage servicing assets, are to be deducted from a bank's core capital elements in determining Tier 1 capital. However, identifiable intangible assets (other than mortgage servicing assets and purchased credit card relationships) acquired on or before February 19, 1992, generally will not be deducted from capital for supervisory purposes, although they will continue to be deducted for applications purposes.

B. \* \* \*

4. *Deferred tax assets.* The amount of deferred tax assets that is dependent upon future taxable income, net of the valuation allowance for deferred tax assets, that may be included in, that is, not deducted from, a bank's capital may not exceed the lesser of (i) the amount of these deferred tax assets that the bank is expected to realize within one year of the calendar quarter-end date, based on its projections of future taxable income for that year,<sup>20</sup> or (ii) 10 percent of Tier 1 capital. The reported amount of deferred tax assets, net of any valuation allowance for deferred tax assets, in excess of the lesser of these two amounts is to be deducted from a bank's core capital elements in determining Tier 1 capital. For purposes of calculating the 10 percent limitation, Tier 1 capital is defined as the sum of core capital elements, net of goodwill, and net of all other identifiable intangible assets other than mortgage servicing assets and purchased credit card relationships, before any disallowed deferred tax assets are deducted. There generally is no limit in Tier 1 capital on the amount of deferred tax assets that can be realized from taxes paid in prior carry-back years or from future reversals of existing taxable temporary differences, but, for banks that have a parent, this may not exceed the amount the bank could reasonably expect its parent to refund.

\* \* \* \* \*

5. In Appendix B to part 208, section II.b. is revised to read as follows:

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

\* \* \* \* \*

### II. \*\*\*

b. A bank's Tier 1 leverage ratio is calculated by dividing its Tier 1 capital (the numerator of the ratio) by its average total consolidated assets (the denominator of the ratio). The ratio will also be calculated using period-end assets whenever necessary, on a case-by-case basis. For the purpose of this leverage ratio, the definition of Tier 1 capital as set forth in the risk-based capital guidelines contained in Appendix A of this part will be used.<sup>2</sup> As a general matter,

<sup>20</sup> To determine the amount of expected deferred-tax assets realizable in the next 12 months, an institution should assume that all existing temporary differences fully reverse as of the report date. Projected future taxable income should not include net operating-loss carry-forwards to be used during that year or the amount of existing temporary differences a bank expects to reverse within the year. Such projections should include the estimated effect of tax-planning strategies that the organization expects to implement to realize net operating losses or tax-credit carry-forwards that would otherwise expire during the year. Institutions do not have to prepare a new 12-month projection each quarter. Rather, on interim report dates, institutions may use the future-taxable-income projections for their current fiscal year, adjusted for any significant changes that have occurred or are expected to occur.

<sup>2</sup> Tier 1 capital for state member banks includes common equity, minority interest in the equity accounts of consolidated subsidiaries, and qualifying noncumulative perpetual preferred stock. In addition, as a general matter, Tier 1 capital

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 Reports), less goodwill; amounts of mortgage servicing assets and purchased credit card relationships that, in the aggregate, are in excess of 100 percent of Tier 1 capital; all other identifiable intangible assets; any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from Tier 1 capital; and deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of the limitation set forth in section II.B.4 of Appendix A of this part.<sup>3</sup>

\* \* \* \* \*

## 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, 3310, 3331-3351, 3907, and 3909.

2. In Appendix A to part 225, sections II.B.1.b.i. through II.B.1.b.v. are revised to read as follows:

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

\* \* \* \* \*

#### II. \* \* \*

#### B. \* \* \*

##### 1. *Goodwill and other intangible assets*

b. *Other intangible assets.* i. All servicing assets, including servicing assets on assets other than mortgages (i.e., non-mortgage servicing assets) are included in this Appendix A as identifiable intangible assets. The only types of identifiable intangible assets that may be included in, that is, not deducted from, an organization's capital are readily marketable mortgage servicing assets and purchased credit card relationships. The total amount of these assets included in capital, in the aggregate, can not exceed 100 percent of Tier 1 capital. Purchased credit card relationships are subject to a separate sublimit of 25 percent of Tier 1 capital.<sup>15</sup>

excludes goodwill; amounts of mortgage servicing assets and purchased credit card relationships that, in the aggregate, exceed 100 percent of Tier 1 capital; purchased credit card relationships that exceed 25 percent of Tier 1 capital; other identifiable intangible assets; and deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of certain limitations. The Federal Reserve may exclude certain investments in subsidiaries or associated companies as appropriate.

<sup>3</sup> Deductions from Tier 1 capital and other adjustments are discussed more fully in section II.B. in Appendix A of this part.

<sup>15</sup> Amounts of mortgage servicing assets and purchased credit card relationships in excess of these limitations, as well as servicing assets on loans other than mortgages and all other identifiable

ii. For purposes of calculating these limitations on mortgage servicing assets and purchased credit card relationships, Tier 1 capital is defined as the sum of core capital elements, net of goodwill, and net of all identifiable intangible assets and similar assets other than mortgage servicing assets and purchased credit card relationships, regardless of the date acquired, but prior to the deduction of deferred tax assets.

iii. Bank holding companies must review the book value of all intangible assets at least quarterly and make adjustments to these values as necessary. The fair value of mortgage servicing assets and purchased credit card relationships also must be determined at least quarterly. This determination shall include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates or account attrition rates.

iv. Examiners will review both the book value and the fair value assigned to these assets, together with supporting documentation, during the inspection process. In addition, the Federal Reserve may require, on a case-by-case basis, an independent valuation of an organization's intangible assets or similar assets.

v. The amount of mortgage servicing assets and purchased credit card relationships that a bank holding company may include in capital shall be the lesser of 90 percent of their fair value, as determined in accordance with this section, or 100 percent of their book value, as adjusted for capital purposes in accordance with the instructions to the Consolidated Financial Statements for Bank Holding Companies (FR Y-9C Report). If both the application of the limits on mortgage servicing assets 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 holding company would deduct only the greater of the two amounts from its core capital elements in determining Tier 1 capital.

\* \* \* \* \*

3. In Appendix A to part 225, section II.B.4. is revised to read as follows:

\* \* \* \* \*

#### II. \* \* \*

#### B. \* \* \*

4. *Deferred tax assets.* The amount of deferred tax assets that is dependent upon future taxable income, net of the valuation allowance for deferred tax assets, that may be included in, that is, not deducted from, a banking organization's capital may not exceed the lesser of (i) the amount of these deferred tax assets that the banking organization is expected to realize within one year of the calendar quarter-end date, based

intangible assets, including core deposit intangibles and favorable leaseholds, are to be deducted from an organization's core capital elements in determining Tier 1 capital. However, identifiable intangible assets (other than mortgage servicing assets and purchased credit card relationships) acquired on or before February 19, 1992, generally will not be deducted from capital for supervisory purposes, although they will continue to be deducted for applications purposes.

on its projections of future taxable income for that year,<sup>23</sup> or (ii) 10 percent of Tier 1 capital. The reported amount of deferred tax assets, net of any valuation allowance for deferred tax assets, in excess of the lesser of these two amounts is to be deducted from a banking organization's core capital elements in determining Tier 1 capital. For purposes of calculating the 10 percent limitation, Tier 1 capital is defined as the sum of core capital elements, net of goodwill, and net of all identifiable intangible assets other than mortgage servicing assets and purchased credit card relationships, before any disallowed deferred tax assets are deducted. There generally is no limit in Tier 1 capital on the amount of deferred tax assets that can be realized from taxes paid in prior carryback years or from future reversals of existing taxable temporary differences.

\* \* \* \* \*

4. In Appendix D to part 225, section II.b. is revised to read as follows:

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

\* \* \* \* \*

#### II. \* \* \*

b. A banking organization's Tier 1 leverage ratio is calculated by dividing its Tier 1 capital (the numerator of the ratio) by its average total consolidated assets (the denominator of the ratio). The ratio will also be calculated using period-end assets whenever necessary, on a case-by-case basis. For the purpose of this leverage ratio, the definition of Tier 1 capital as set forth in the risk-based capital guidelines contained in Appendix A of this part will be used.<sup>3</sup> As a general matter, average total consolidated

<sup>23</sup> To determine the amount of expected deferred tax assets realizable in the next 12 months, an institution should assume that all existing temporary differences fully reverse as of the report date. Projected future taxable income should not include net operating loss carryforwards to be used during that year or the amount of existing temporary differences a bank holding company expects to reverse within the year. Such projections should include the estimated effect of tax planning strategies that the organization expects to implement to realize net operating losses or tax credit carryforwards that would otherwise expire during the year. Institutions do not have to prepare a new 12 month projection each quarter. Rather, on interim report dates, institutions may use the future taxable income projections for their current fiscal year, adjusted for any significant changes that have occurred or are expected to occur.

<sup>3</sup> Tier 1 capital for banking organizations includes common equity, minority interest in the equity accounts of consolidated subsidiaries, qualifying noncumulative perpetual preferred stock, and qualifying cumulative perpetual preferred stock. (Cumulative perpetual preferred stock is limited to 25 percent of Tier 1 capital.) In addition, as a general matter, Tier 1 capital excludes goodwill; amounts of mortgage servicing assets and purchased credit card relationships that, in the aggregate, exceed 100 percent of Tier 1 capital; purchased credit card relationships that exceed 25 percent of Tier 1 capital; all other identifiable intangible assets (including non-mortgage servicing assets); and deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of certain limitations. The Federal Reserve may exclude certain investments in subsidiaries or associated companies as appropriate.



assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the organization's Consolidated Financial Statements (FR Y-9C Report), less goodwill; amounts of mortgage servicing assets and purchased credit card relationships that, in the aggregate, are in excess of 100 percent of Tier 1 capital; amounts of purchased credit card relationships in excess of 25 percent of Tier 1 capital; all other identifiable intangible assets (including non-mortgage servicing assets); any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from Tier 1 capital; and deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of the limitation set forth in section II.B.4 of Appendix A of this part.<sup>4</sup>

By order of the Board of Governors of the Federal Reserve System, July 28, 1997.  
**William W. Wiles,**  
*Secretary of the Board.*

#### **Federal Deposit Insurance Corporation 12 CFR Chapter III**

For the reasons set forth in the joint preamble, part 325 of chapter III of title 12 of the Code of Federal Regulations is proposed to be amended as follows:

#### **PART 325—CAPITAL MAINTENANCE**

1. The authority citation for part 325 continues 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), 1831o, 1835, 3907, 3909, 4808; Pub. L. 102-233, 105 Stat. 1761, 1789, 1790 (12 U.S.C. 1831n note); Pub. L. 102-242, 105 Stat. 2236, 2355, 2386 (12 U.S.C. 1828 note).

2. In § 325.2, paragraph (n) is revised to read as follows:

#### **§ 325.2 Definitions.**

(n) Mortgage servicing assets means those balance sheet assets (net of any related valuation allowances) that represent the rights to perform the servicing function for mortgage loans that have been securitized or are owned by others. Mortgage servicing assets must be amortized in proportion to, and over the period of, estimated net servicing income. For purposes of determining regulatory capital under this part, mortgage servicing assets will be recognized only to the extent that the

rights meet the conditions, limitations, and restrictions described in § 325.5 (f).

#### **§ 325.2 [Amended]**

3. In § 325.2, paragraphs (s), (t), and (v) are amended by removing the words "mortgage servicing rights" and adding in their place the words "mortgage servicing assets" each time they appear.

4. In § 325.5, paragraph (f) is revised to read as follows:

#### **§ 325.5 Miscellaneous.**

(f) *Treatment of mortgage servicing assets and credit card relationships.* For purposes of determining Tier 1 capital under this part, mortgage servicing assets and purchased credit card relationships will be deducted from assets and from equity capital to the extent that the mortgage servicing assets and purchased credit card relationships do not meet the conditions, limitations, and restrictions described in this section.

(1) *Valuation.* The fair value of mortgage servicing assets and purchased credit card relationships shall be estimated at least quarterly. The quarterly fair value estimate shall include adjustments for any significant changes in the original valuation assumptions, including changes in prepayment estimates or attrition rates. The FDIC in its discretion may require independent fair value estimates on a case-by-case basis where it is deemed appropriate for safety and soundness purposes.

(2) *Fair value limitation.* For purposes of calculating Tier 1 capital under this part (but not for financial statement purposes), the balance sheet assets for mortgage servicing assets and purchased credit card relationships will each be reduced to an amount equal to the lesser of:

(i) 90 percent of the fair value of these assets, determined in accordance with paragraph (f)(1) of this section; or  
 (ii) 100 percent of the remaining unamortized book value of these assets (net of any related valuation allowances), determined in accordance with the instructions for the preparation of the Consolidated Reports of Income and Condition (Call Reports).

(3) *Tier 1 capital limitation.* The maximum allowable amount of mortgage servicing assets and purchased credit card relationships, in the aggregate, will be limited to the lesser of:

(i) 100 percent of the amount of Tier 1 capital that exists before the deduction of any disallowed mortgage servicing assets, any disallowed purchased credit card relationships, and any disallowed deferred tax assets; or

(ii) The amount of mortgage servicing assets and purchased credit card relationships, determined in accordance with paragraph (f)(2) of this section.

(4) *Tier 1 capital sublimit.* In addition to the aggregate limitation on mortgage servicing assets and purchased credit card relationships set forth in paragraph (f)(3) of this section, a sublimit will apply to purchased credit card relationships. The maximum allowable amount of purchased credit card relationships, in the aggregate, will be limited to the lesser of:

(i) Twenty-five percent of the amount of Tier 1 capital that exists before the deduction of any disallowed mortgage servicing assets, any disallowed purchased credit card relationships, and any disallowed deferred tax assets; or

(ii) The amount of purchased credit card relationships, determined in accordance with paragraph (f)(2) of this section.

#### **§ 325.5 [Amended]**

5. In § 325.5, paragraphs (g)(2)(i)(B) and (g)(5) are amended by removing the words "mortgage servicing rights" and adding in their place the words "mortgage servicing assets" each time they appear.

#### **Appendix A to Part 325 [Amended]**

6. In appendix A to part 325, the words "mortgage servicing rights" are removed and the words "mortgage servicing assets" are added each time they appear in section I.A.1., section I.B.(1) and footnote 8 to section I.B.(1), section II.C., and Table I—Definition of Qualifying Capital and footnote 2 to Table I.

#### **Appendix B to Part 325 [Amended]**

7. In appendix B to part 325, section IV.A. and footnote 1 to section IV. A. are amended by removing the words "mortgage servicing rights" and adding in their place the words "mortgage servicing assets" each time they appear.

By order of the Board of Directors.

Dated at Washington, D.C., this 22nd day of July, 1997.

Federal Deposit Insurance Corporation.

**Robert E. Feldman,**  
*Executive Secretary.*

#### **Office of Thrift Supervision**

#### **12 CFR CHAPTER V**

For the reasons outlined in the joint preamble, the Office of Thrift Supervision hereby proposes to amend 12 CFR, Chapter V, as set forth below:

#### **PART 565—PROMPT CORRECTIVE ACTION**

1. The authority citation for part 565 continues to read as follows:

<sup>4</sup> Deductions from Tier 1 capital and other adjustments are discussed more fully in section II.B. in Appendix A of this part.



**Authority:** 12 U.S.C. 1831o.

2. Section 565.2 is amended by revising paragraph (f) to read as follows:

**§ 565.2 Definitions.**

\* \* \* \* \*

(f) *Tangible equity* means the amount of a savings association's core capital as computed in § 567.5(a) of this chapter plus the amount of its outstanding cumulative perpetual preferred stock (including related surplus), minus intangible assets as defined in § 567.1(m) of this chapter that have not been previously deducted in calculating core capital.

\* \* \* \* \*

**PART 567—CAPITAL**

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

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

2. Section 567.1 is amended by revising paragraph (m) to read as follows:

**§ 567.1 Definitions**

\* \* \* \* \*

(m) *Intangible assets.* The term intangible assets means assets considered to be intangible assets under generally accepted accounting principles. These assets include, but are not limited to, goodwill, favorable leaseholds, core deposit premiums, and purchased credit card relationships. Servicing assets are not intangible assets under this definition.

\* \* \* \* \*

3. Section 567.5 is amended by revising paragraph (a)(2)(ii) to read as follows:

**§ 567.5 Components of capital.**

(a) \* \* \*

(2) \* \* \*

(ii) Servicing assets that are not includable in tangible and core capital pursuant to § 567.12 of this part are deducted from assets and capital in computing core capital.

\* \* \* \* \*

4. Section 567.6 is amended by revising paragraphs (a)(1)(iv)(L) and (a)(1)(iv)(M) to read as follows:

**§ 567.6 Risk-based capital credit risk-weight categories.**

(a) \* \* \*

(1) \* \* \*

(iv) \* \* \*

(L) Mortgage servicing assets and intangible assets includable in core capital pursuant to § 567.12 of this part;

(M) Interest-only strips receivable;

\* \* \* \* \*

5. Section 567.9 is amended by revising paragraph (c)(1) to read as follows:

**§ 567.9 Tangible capital requirement.**

\* \* \* \* \*

(c) \* \* \*

(1) Intangible assets, as defined in § 567.1(m) of this part, and servicing assets not includable in core and tangible capital pursuant to § 567.12 of this part.

\* \* \* \* \*

6. Section 567.12 is amended by revising the section heading and paragraphs (a) through (c), paragraph (d) introductory text, and paragraphs (e) and (f) to read as follows:

**§ 567.12 Intangible assets and servicing assets.**

(a) *Scope.* This section prescribes the maximum amount of intangible assets and servicing assets that savings associations may include in calculating tangible and core capital.

(b) *Computation of core and tangible capital.* (1) Purchased credit card relationships may be included (that is, not deducted) in computing core capital in accordance with the restrictions in this section, but must be deducted in computing tangible capital.

(2) Mortgage servicing assets may be included in computing core and tangible capital, in accordance with the restrictions in this section.

(3) Non mortgage-related servicing assets are deducted in computing core and tangible capital.

(4) Intangible assets, as defined in § 567.1(m) of this part, other than purchased credit card relationships described in paragraph (a)(1) of this section and core deposit intangibles described in paragraph (g)(3) of this section, are deducted in computing tangible and core capital.

(c) *Market valuations.* The OTS reserves the authority to require any savings association to perform an independent market valuation of assets subject to this section on a case-by-case basis or through the issuance of policy guidance. An independent market valuation, if required, shall be conducted in accordance with any policy guidance issued by the OTS. A

required valuation shall include adjustments for any significant changes in original valuation assumptions, including changes in prepayment estimates or attrition rates. The valuation shall determine the current fair value of assets subject to this section. This independent market valuation may be conducted by an independent valuation expert evaluating the reasonableness of the internal calculations and assumptions used by the association in conducting its internal analysis. The association shall calculate an estimated fair value for assets subject to this section at least quarterly regardless of whether an independent valuation expert is required to perform an independent market valuation.

(d) *Value limitation.* For purposes of calculating core capital under this part (but not for financial statement purposes), purchased credit card relationships and mortgage servicing assets must be valued at the lesser of:

\* \* \* \* \*

(e) *Core capital limitation—(1) Aggregate limit.* The maximum aggregate amount of mortgage servicing assets and purchased credit card relationships that may be included in core capital shall be limited to the lesser of:

(i) 100 percent of the amount of core capital computed before the deduction of any disallowed mortgage servicing assets and purchased credit card relationships; or

(ii) The amount of mortgage servicing assets and purchased credit card relationships determined in accordance with paragraph (d) of this section.

(2) *Reduction by deferred tax liability.* Associations may elect to reduce the amount of their disallowed (i.e., not includable in capital) mortgage servicing assets exceeding the 100 percent limit by the amount of any associated deferred tax liability.

(3) *Sublimit for purchased credit card relationships.* In addition to the aggregate limitation in paragraph (e)(1) of this section, a sublimit shall apply to purchased credit card relationships. The maximum allowable amount of such assets shall be limited to the lesser of:

(i) 25 percent of the amount of core capital computed before the deduction of any disallowed mortgage servicing assets and purchased credit card relationships; or

(ii) The amount of purchased credit card relationships determined in accordance with paragraph (d) of this section.

(f) *Tangible capital limitation.* The maximum amount of mortgage servicing assets that may be included in tangible

capital shall be the same amount includable in core capital in accordance with the limitations set by paragraph (e)(1) of this section.

\* \* \* \* \*

Dated: July 7, 1997.

By the Office of Thrift Supervision.

**Nicolas P. Retsinas,**

*Director.*

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