FEDERAL RESERVE BANK
OF DALLAS

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

DALLAS, TEXAS
75265-5906

October 17, 1997

Notice 97-90

TO: The Chief Executive Officer of
each financial institution in the
Eleventh Federal Reserve District

SUBJECT

**Revised Pamphlets for
Capital Adequacy Guidelines, Regulation C
(Home Mortgage Disclosure), and Regulation M
(Consumer Leasing)**

DETAILS

The Board of Governors of the Federal Reserve System has published revised pamphlets for Capital Adequacy Guidelines, with various effective dates; Regulation C, effective July 1, 1997; and Regulation M, effective April 1, 1997.

ENCLOSURES

The revised pamphlets are enclosed. Please insert them in your Regulations binders.

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 regarding Capital Adequacy Guidelines, please contact Dorsey Davis at (214) 922-6051. For more information regarding Regulation C or Regulation M, please contact Eugene Coy at (214) 922-6201.

For additional copies of this Bank's notice or the revised pamphlets, contact the Public Affairs Department at (214) 922-5254.

Sincerely yours,

Robert D. McTeer, Jr.

Board of Governors of the Federal Reserve System

Regulation C
Home Mortgage Disclosure

12 CFR 203; as amended effective July 1, 1997

Any inquiry relating to this regulation should be addressed to the Federal Reserve Bank in the District in which the inquiry arises.

August 1997

Contents

STATUTORY PROVISIONS

Regulation C
Home Mortgage Disclosure

12 CFR 203*; as amended effective July 1, 1997

SECTION 203.1—Authority, Purpose, and Scope

(a) *Authority.* This regulation is issued by the Board of Governors of the Federal Reserve System ("Board") pursuant to the Home Mortgage Disclosure Act (12 USC 2801 et seq.), as amended. The information-collection requirements have been approved by the U.S. Office of Management and Budget under 44 USC 3501 et seq. and have been assigned OMB No. 7100-0247.

(b) *Purpose.*

(1) This regulation implements the Home Mortgage Disclosure Act, which is intended to provide the public with loan data that can be used—

(i) to help determine whether financial institutions are serving the housing needs of their communities;

(ii) to assist public officials in distributing public-sector investments so as to attract private investment to areas where it is needed; and

(iii) to assist in identifying possible discriminatory lending patterns and enforcing antidiscrimination statutes.

(2) Neither the act nor this regulation is intended to encourage unsound lending practices or the allocation of credit.

(c) *Scope.* This regulation applies to certain financial institutions, including banks, saving associations, credit unions, and other mortgage lending institutions, as defined in section 203.2(e). It requires an institution to report data to its supervisory agency about home-purchase and home-improvement loans it originates or purchases, or for which it receives applications; and to disclose certain data to the public.

(d) *Loan aggregation and central data depositories.* Using the loan data made available by financial institutions, the Federal Financial Institutions Examination Council will prepare disclosure statements and will produce various reports for individual institutions for each metropolitan statistical area (MSA), showing lending patterns by location, age of housing stock, income level, sex, and racial characteristics. The disclosure statements and reports will be available to the public at central data depositories located in each MSA. A listing of central data depositories can be obtained from the Federal Financial Institutions Examination Council, Washington, D.C. 20006.

SECTION 203.2—Definitions

In this regulation—

(a) *Act* means the Home Mortgage Disclosure Act (12 USC 2801 et seq.), as amended.

(b) *Application* means an oral or written request for a home-purchase or home-improvement loan that is made in accordance with procedures established by a financial institution for the type of credit requested.

(c) *Branch office* means—

(1) any office of a bank, savings association, or credit union that is approved as a branch by a federal or state supervisory agency, but excludes free-standing electronic terminals such as automated teller machines;

(2) any office of a mortgage-lending institution (other than a bank, savings association, or credit union) that takes applications from the public for home-purchase or home-improvement loans. A mortgage-lending institution is also deemed to have a branch office in an MSA if, in the preceding calendar year, it received applications for, originated, or purchased five or more home-purchase or home-improvement loans on property located in that MSA.

(d) *Dwelling* means a residential structure (whether or not it is attached to real property) located in a state of the United States of America, the District of Columbia, or the Commonwealth of Puerto Rico. The term in-

* Code of Federal Regulations, title 12, chapter II, part 203.

cludes an individual condominium unit, cooperative unit, or mobile or manufactured home.

(e) *Financial institution* means—

(1) a bank, savings association, or credit union that originated in the preceding calendar year a home-purchase loan (other than temporary financing such as a construction loan) including a refinancing of a home-purchase loan, secured by a first lien on a one- to four-family dwelling if—

(i) the institution is federally insured or regulated; or

(ii) the loan is insured, guaranteed, or supplemented by any federal agency; or

(iii) the institution intended to sell the loan to the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation;

(2) a for-profit mortgage-lending institution (other than a bank, savings association, or credit union) whose home-purchase loan originations (including refinancings of home-purchase loans) equaled or exceeded 10 percent of its loan-origination volume, measured in dollars, in the preceding calendar year.

(f) *Home-improvement loan* means any loan that—

(1) is for the purpose, in whole or in part, of repairing, rehabilitating, remodeling or improving a dwelling or the real property on which it is located; and

(2) is classified by the financial institution as a home-improvement loan.

(g) *Home-purchase loan* means any loan secured by and made for the purpose of purchasing a dwelling.

(h) *Metropolitan statistical area or MSA* means a metropolitan statistical area or a primary metropolitan statistical area, as defined by the U.S. Office of Management and Budget.

SECTION 203.3—Exempt Institutions

(a) *Exemption based on location, asset size, or number of home-purchase loans.*

(1) A bank, savings association, or credit union is exempt from the requirements of this regulation for a given calendar year if on the preceding December 31—

(i) the institution had neither a home office nor a branch office in an MSA; or

(ii) the institution's total assets were at or below the asset threshold established by the Board. For data collection in 1997, the asset threshold is $28 million as of December 31, 1996. For subsequent years, the Board will adjust the threshold based on the year-to-year change in the average of the Consumer Price Index for Urban Wage Earners and Clerical Workers, not seasonally adjusted, for each 12-month period ending in November, with rounding to the nearest million. The Board will publish any adjustment in the asset figure in December.

(2) A for-profit mortgage lending institution (other than a bank, savings association, or credit union) is exempt from the requirements of this regulation for a given calendar year if—

(i) the institution had neither a home office nor a branch office in an MSA on the preceding December 31; or

(ii) the institution's total assets combined with those of any parent corporation were $10 million or less on the preceding December 31, and the institution originated fewer than 100 home-purchase loans in the preceding calendar year.

(b) *Exemption based on state law.*

(1) A state-chartered or state-licensed financial institution is exempt from the requirements of this regulation if the Board determines that the institution is subject to a state disclosure law that contains requirements substantially similar to those imposed by this regulation and contains adequate provisions for enforcement.

(2) Any state, state-chartered, or state-licensed financial institution, or association of such institutions may apply to the Board for any exemption under this paragraph.

(3) An institution that is exempt under this paragraph shall submit the data required by the state disclosure law to its state supervisory agency for purposes of aggregation.

(c) *Loss of exemption.*

(1) An institution losing an exemption that

was based on the criteria set forth in paragraph (a) of this section shall comply with this regulation beginning with the calendar year following the year in which it lost its exemption.

(2) An institution losing an exemption that was based on state law under paragraph (b) of this section shall comply with this regulation beginning with the calendar year following the year for which it last reported loan data under the state disclosure law.

SECTION 203.4—Compilation of Loan Data

(a) *Data format and itemization.* A financial institution shall collect data regarding applications for, and originations and purchases of, home-purchase and home-improvement loans (including refinancings of both) for each calendar year. These transactions shall be recorded, within 30 calendar days after the end of each calendar quarter in which final action is taken (such as origination or purchase of a loan, or denial or withdrawal of an application), on a register in the format prescribed in appendix A of this part and shall include the following items:

(1) A number for the loan or loan application, and the date the application was received.

(2) The type and purpose of the loan.

(3) The owner-occupancy status of the property to which the loan relates.

(4) The amount of the loan or application.

(5) The type of action taken, and the date.

(6) The location of the property to which the loan relates, by MSA, state, county, and census tract, if the institution has a home or branch office in that MSA.

(7) The race or national origin and sex of the applicant or borrower, and the gross annual income relied upon in processing the application.

(8) The type of entity purchasing a loan that the institution originates or purchases and then sells within the same calendar year.

(b) *Collection of data on race or national origin, sex, and income.*

(1) A financial institution shall collect data about the race or national origin and sex of the applicant or borrower as prescribed in appendix B. If the applicant or borrower chooses not to provide the information, the lender shall note the data on the basis of visual observation or surname, to the extent possible.

(2) Race or national origin, sex, and income data may but need not be collected for—

(i) loans purchased by the financial institution; or

(ii) applications received or loans originated by a bank, savings association, or credit union with assets on the preceding December 31 of $30 million or less.

(c) *Optional data.* A financial institution may report the reasons it denied a loan application.

(d) *Excluded data.* A financial institution shall not report—

(1) loans originated or purchased by the financial institution acting in a fiduciary capacity (such as trustee);

(2) loans on unimproved land;

(3) temporary financing (such as bridge or construction loans);

(4) the purchase of an interest in a pool of loans (such as mortgage-participation certificates); or

(5) the purchase solely of the right to service loans.

(e) *Data reporting under CRA for banks and savings associations with total assets of $250 million or more and banks and savings associations that are subsidiaries of a holding company whose total banking and thrift assets are $1 billion or more.* As required by agency regulations that implement the Community Reinvestment Act, banks and savings associations that had total assets of $250 million or more (or are subsidiaries of a holding company with total banking and thrift assets of $1 billion or more) as of December 31 for each of the immediately preceding two years, shall also collect the location of property located outside the MSAs in which the institution has a home or branch office, or outside any MSAs.

SECTION 203.5—Disclosure and Reporting

(a) *Reporting to agency.* By March 1 following the calendar year for which the loan data are compiled, a financial institution shall send its complete loan application register to the agency office specified in appendix A of this regulation, and shall retain a copy for its records for a period of not less than three years.

(b) *Public disclosure of statement.*

(1) A financial institution shall make its mortgage loan disclosure statement (to be prepared by the Federal Financial Institutions Examination Council) available to the public at its home office no later than three business days after receiving it from the Examination Council.

(2) In addition, a financial institution shall either—

(i) make its disclosure statement available to the public (within 10 business days of receiving it) in at least one branch office in each additional MSA where the institution has offices (the disclosure statement need only contain data relating to the MSA where the branch is located); or

(ii) post the address for sending written requests for the disclosure statement in the lobby of each branch office in an MSA where the institution has offices, and mail or deliver a copy of the disclosure statement, within 15 calendar days of receiving a written request (the disclosure statement need only contain data relating to the MSA for which the request is made). Including the address in the general notice required under paragraph (e) of this section satisfies this requirement.

(c) *Public disclosure of loan application register.* A financial institution shall make its loan application register available to the public after modifying it in accordance with appendix A. An institution shall make its modified register available following the calendar year for which the data are compiled, by March 31 for a request received on or before March 1, and within 30 days for a request received after March 1. The modified register need only contain data relating to the MSA for which the request is made.

(d) *Availability of data.* A financial institution shall make its modified register available to the public for a period of three years and its disclosure statement available for a period of five years. An institution shall make the data available for inspection and copying during the hours the office is normally open to the public for business. It may impose a reasonable fee for any cost incurred in providing or reproducing the data.

(e) *Notice of availability.* A financial institution shall post a general notice about the availability of its HMDA data in the lobby of its home office and of each branch office located in an MSA. It shall promptly upon request provide the location of the institution's offices where the statement is available for inspection and copying, or it may include the location in its notice.

SECTION 203.6—Enforcement

(a) *Administrative enforcement.* A violation of the act or this regulation is subject to administrative sanctions as provided in section 305 of the act, including the imposition of civil money penalties, where applicable. Compliance is enforced by the agencies listed in appendix A of this regulation.

(b) *Bona fide errors.* An error in compiling or recording loan data is not a violation of the act or this regulation if it was unintentional and occurred despite the maintenance of procedures reasonably adopted to avoid such errors.

APPENDIX A—Form and Instructions for Completion of HMDA Loan/Application Register

Paperwork Reduction Act Notice

Public reporting burden for collection of this information is estimated to vary from 10 to 10,000 hours per response, with an average of 202 hours per response, for state member banks and 160 hours per response for mortgage banking subsidiaries, including time to gather and maintain the data needed and to review instructions and complete the information collection. This report is required by law (12 USC 2801–2810 and 12 CFR 203). An agency may not conduct or sponsor, and an organization is not required to respond to, a collection of information unless it displays a currently valid OMB control number. The OMB control number for this information collection is 7100-0247. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing the burden, to Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551; and to the Office of Information and Regulatory Affairs, Office of Management and Budget, Washington, D.C. 20503.

I. Who Must File a Report

A. *Depository institutions.*

1. Subject to the exception discussed below, banks, savings associations, and credit unions must complete a register listing data about loan applications received, loans originated, and loans purchased if on the preceding December 31 an institution—
   a. had assets of more than the asset threshold for coverage as published by the Board each year in December, and
   b. had a home or a branch office in a "metropolitan statistical area" or a "primary metropolitan statistical area" (both are referred to in these instructions by the term "MSA").
2. For data collection in 1997, the asset threshold is $28 million in total assets as of December 31, 1996.
3. *Example:* If on December 31 you had a home or branch office in an MSA and your assets exceeded the asset threshold, you must complete a register that lists the home-purchase and home-improvement loans that you originate or purchase (and also lists applications that did not result in an origination) beginning January 1.

B. *Depository institutions—exception.* You need not complete a register—even if you meet the tests for asset size and location—if your institution is a bank, savings association, or credit union that made *no* first-lien home-purchase loans (including refinancings) on one- to four-family dwellings in the preceding calendar year. This exception does not apply in the case of nondepository institutions.

C. *Other lending institutions.* Subject to the exception discussed below, for-profit mortgage lending institutions (other than banks, savings associations, and credit unions) must complete a register listing data about loan applications received, loans originated, and loans purchased if the institution had a home or branch office in an MSA on the preceding December 31, and—

1. had assets of more than $10 million (based on the combined assets of the institution and any parent corporation) on the preceding December 31, or
2. originated 100 or more home-purchase loans (including refinancings of such loans) during the preceding calendar year, regardless of asset size.

D. *Other lending institutions—exception.* You need not complete a register—even if you meet the tests for location and asset size or number of home-purchase loans—if your institution is a for-profit mortgage lender (other than a bank, savings association, or credit union) and the home-purchase loans that you originated in the preceding calendar year (including refinancings) came to less than 10 percent of your total loan-origination volume, measured in dollars.

E. If you are the subsidiary of a bank or savings association, you must complete a separate register for your institution. You will submit the register, directly or through your parent, to the agency that supervises your parent. (See paragraph VI.)

F. Institutions that are specifically exempted by the Federal Reserve Board from complying with the federal Home Mortgage Disclosure Act because they are covered by a similar state law on mortgage loan disclosures must use the disclosure form required by their state law and submit the data to their state supervisory agency.

II. Required Format and Reporting Procedures

A. Institutions must submit data to their supervisory agencies in an automated, machine-readable form. The format must conform exactly to that of form FR HMDA-LAR, including the order of columns, column headings, etc. Contact your federal supervisory agency for information regarding procedures and technical specifications for automated data submission; in some cases, agencies also make software for automated data submission available to institutions. The data must be edited before submission, using the edits included in the agency-supplied software or equivalent edits in software available from vendors or developed in-house. (Institutions that report 25 or fewer entries on their HMDA-LAR may collect and report the data in paper form. An institution that submits its register in nonautomated form must send two copies that are typed or computer printed and must use the format of form FR HMDA-LAR (but need not use the form itself). Each page must be numbered, and the total number of pages must be given (for example, "Page 1 of 3").

B. The required data are to be entered in the register for each loan origination, each application acted on, and each loan purchased during the calendar year. Your institution should decide on the procedure it wants to follow—for example, whether to begin entering the required data when an application is received, or to wait until final action is taken (such as when a loan goes to closing or an application is denied). Keep in mind that an application is to be reported in the calendar year when final action is taken. Report loan originations in the year they go to closing; if an application has been approved but has not yet gone to closing at year-end, report it the following year.

C. Your institution may collect the data on separate registers at different branches, or on separate registers for different loan types (such as for home-purchase or home-improvement loans, or for loans on multifamily dwellings). But make sure the application or loan numbers (discussed under paragraph V.A.1., below) are unique.

D. Entries need *not* be grouped on your register by MSA, or chronologically, or by census tract numbers, or in any other particular order.

E. Applications and loans must be recorded on your register within 30 calendar days after the end of the calendar quarter in which final action (such as origination or purchase of a loan, or denial or withdrawal of an application) is taken. The type of purchaser for loans sold need not be included in these quarterly updates.

III. Submission of HMDA-LAR and Public Release of Data

A. You must submit the data for your institution to the office specified by your supervisory agency no later than March 1 following the calendar year for which the data are compiled. A list of the agencies appears at the end of these instructions.

B. You must submit all required data to your supervisory agency *in one complete package*, with the prescribed transmittal sheet. An officer of your institution must certify to the accuracy of the data. Any additional data submissions that become necessary (for example, because you discover that data were omitted from the initial submission, or because revisions are called for) also must be accompanied by a transmittal sheet.

C. The transmittal sheet must state the total number of line entries contained in the accompanying data submission. If the data submission involves revisions or deletions of previously submitted data, state the total of *all* line entries contained in *that submission*, including both those representing revisions or deletions of previously submitted entries, and those that are being resubmitted unchanged or are being submitted for the first time. If you are a depository institution, you also are asked to include a list of the MSAs where you have a home or branch office.

D. *Availability of disclosure statement.*

1. The Federal Financial Institutions Examination Council (FFIEC) will prepare a disclosure statement from the date you submit. Your disclosure statement will be returned to the name and address indicated on

the transmittal sheet. Within three business days of receiving the disclosure statement, you must make a copy available at your home office for inspection by the public. For these purposes, a business day is any calendar day other than a Saturday, Sunday, or legal public holiday. You also must either—

a. make your disclosure statement available to the public, within 10 business days of receiving it from the FFIEC, in at least one branch office in each additional MSA where you have offices (the disclosure statement need only contain data relating to properties in the MSA where the branch office is located); or

b. post in the lobby of each branch office in an MSA the address where a written request for the disclosure statement may be sent, and mail or deliver a copy of the statement to any person requesting it, within 15 calendar days of receiving a written request. The disclosure statement need only contain data relating to the MSA for which the request is made.

2. You may make the disclosure statement available in paper form or, if the person requesting the data agrees, in automated form (such as by PC diskette or computer tape).

E. *Availability of modified loan application register.*

1. To protect the privacy of applicants and borrowers, an institution must modify its loan application register by removing the following information before releasing it to the public: the application or loan number, date application received, and date of action taken.

2. You may make the modified register available in paper or automated form (such as by PC diskette or computer tape). Although you are not required to make the modified loan application register available in census-tract order, you are strongly encouraged to do so in order to enhance its utility to users.

3. You must make your modified register available following the calendar year for which the data are compiled, by March 31 for a request received on or before March 1, and within 30 days for a request received after March 1. You are not required to prepare a modified loan application register in advance of receiving a request from the public for this information, but must be able to respond to a request within 30 days. A modified register need only reflect data relating to the MSA for which the request is made.

F. *Posters.*

1. *Suggested language.* Some of the agencies provide HMDA posters that you can use to inform the public of the availability of your HMDA data, or you may create your own posters. If you print your own, the following language is suggested but is not required:

HOME MORTGAGE DISCLOSURE ACT NOTICE

The HMDA data about our residential mortgage lending are available for review. The data show geographic distribution of loans and applications; race, gender, and income of applicants and borrowers; and information about loan approvals and denials. Inquire at this office regarding the locations where HMDA data may be inspected.

2. *Additional language for institutions making the disclosure statement available upon request.* An institution that makes its disclosure statement available upon request instead of at branch offices must post a notice informing the public of the address to which a request should be sent. For example, the institution could include the following sentence in its general notice: "To receive a copy of these data send a written request to [address]."

IV. Types of Loans and Applications Covered and Excluded by HMDA

A. *Types of loans and applications to be reported*

1. Report the data on home-purchase and home-improvement loans that you originated (that is, loans that were closed in your name) and loans that you purchased during the calendar year covered by the report. Report these data even if the loans were subsequently sold by your institution. Include refinancings of home-purchase and home-improvement loans.

2. Report the data for applications for home-purchase and home-improvement loans that did not result in originations—for example, applications that your institution denied or that the applicant withdrew during the calendar year covered by the report.

3. In the case of brokered loan applications or applications forwarded to you through a correspondent, report as originations loans that you approved and subsequently acquired according to a preclosing arrangement (whether or not they closed in your institution's name). Additionally, report the data for all applications that did not result in originations—for example, applications that your institution denied or that the applicant withdrew during the calendar year covered by the report (whether or not they would have closed in your institution's name). For all of these loans and applications, report the race or national origin, sex, and income information, unless your institution is a bank, savings association, or credit union with assets of $30 million or less on the preceding December 31.

4. Originations are to be reported only once. If you are the loan broker or correspondent, do not report as originations loans that you forwarded to another lender for approval prior to closing, and that were approved and subsequently acquired by that lender (whether or not they closed in your name).

5. Report applications that were received in the previous calendar year but were acted upon during the calendar year covered by the current register.

B. *Data to be excluded.* Do not report loans or applications for loans of the following types:

1. Loans that, although secured by real estate, are made for purposes other than home purchase, home improvement, or refinancing (For example, do not report a loan secured by residential real property for purposes of financing college tuition, a vacation, or goods for business inventory.)

2. Loans made in a fiduciary capacity (for example, by your trust department)

3. Loans on unimproved land

4. Construction or bridge loans and other temporary financing

5. The purchase of an interest in a pool of loans (such as mortgage-participation certificates)

6. The purchase solely of the right to service loans

V. Instructions for Completion of Loan/Application Register

A. *Application or loan information*

1. *Application or loan number.* Enter an identifying number that can be used later to retrieve the loan or application file. It can be any number of your choosing (not exceeding 25 characters). You may use letters, numerals, or a combination of both.

Make sure that all numbers are unique within your institution. If your register contains data for branch offices, for example, you could use a letter or a numerical code to identify the loans or applications of different branches, or could assign a certain series of numbers to particular branches to avoid duplicate numbers. You are strongly encouraged *not* to use the applicant's or borrower's name or Social Security number, for privacy reasons.

2. *Date application received.* Enter the date the loan application was received by your institution by month, day, and year, using numerals in the form MM/DD/YY (for example, 01/15/92). If your institution normally records the date shown on the application form, you may use that date instead. Enter "NA" for loans purchased by your institution.

3. *Type.* Indicate the type of loan or application by entering the applicable code from the following:

1—Conventional (any loan other than FHA, VA or FmHA loans)
2—FHA-insured (Federal Housing Administration)
3—VA-guaranteed (Veterans Administration)
4—FmHA-insured (Farmers Home Administration)

4. *Purpose.* Indicate the purpose of the loan or application by entering the applicable code from the following:

1—Home purchase (one- to four-family)
2—Home improvement (one- to four-family)
3—Refinancing (home purchase or home improvement, one- to four-family)
4—Multifamily dwelling (home purchase, home improvement, and refinancings)

5. *Explanation of purpose codes*

Code 1: Home purchase

a. This code applies to loans and applications made for the purpose of purchasing a residential dwelling for one to four families, if the loan is to be secured by the dwelling being purchased or by another dwelling.

b. At your option, you may use code 1 for loans that are made for home-improvement purposes but are secured by a first lien, if you normally classify such first-lien loans as home-purchase loans.

Code 2: Home improvement

a. Code 2 applies to loans and applications for loans if (i) a portion of the proceeds is to be used for repairing, rehabilitating, remodeling, or improving a one- to four-family residential dwelling, or the real property upon which it is located, and (ii) the loan is classified as a home-improvement loan.

b. Report both secured and unsecured loans.

c. At your option, you may report data about home-equity lines of credit—even if the credit line is not recorded on your institution's books as a home-improvement loan. If you choose to do so, you may report a home-equity line of credit as a home-improvement loan if the borrower or applicnt indicates, at the time of application or when the account is opened, that some portion of the proceeds will be used for home improvement. (See paragraph 8. "Loan amount," below.) If you report originations of home-equity lines of credit, you must also report applications for such loans that did not result in originations.

Code 3: Refinancings

a. Use this code for refinancings (and applications for refinancings) of loans secured by one- to four-family residential dwellings. A refinancing involves the satisfaction of an existing obligation that is replaced by a new obligation undertaken by the same borrower. But do not report a refinancing if, under the loan agreement, you are unconditionally obligated to refinance the obligation, or you are obligated to refinance the obligation subject to conditions within the borrower's control.

b. Use this code whether or not you were the original creditor on the loan being refinanced, and whether or not the refinancing involves an increase in the outstanding principal.

c. You may report all refinancings of loans secured by one- to four-family residential dwellings, regardless of the purpose of or amount outstanding on the original loan, and regardless of the amount of new money (if any) that is for home-purchase or home-improvement purposes.

Code 4: Multifamily dwelling

a. Use this code for loans and loan applications on dwellings for five or more families, including home-purchase loans, refinancings, and loans for repairing, rehabilitation, and remodeling purposes.

b. Do not use this code for loans on individual condominium or cooperative units; use codes 1, 2, or 3 for such loans, as applicable.

6. *Owner occupancy.* Indicate whether the property to which the loan or loan application relates is to be owner-occupied as a principal dwelling by entering the applicable code from the following:

1—Owner-occupied as a principal dwelling
2—Not owner-occupied
3—Not applicable

7. *Explanation of codes*

a. Use code 2 for second homes or vacation homes, as well as rental properties.

b. Use code 2 only for nonoccupant loans, or applications for nonoccupant loans, related to one- to four-family dwellings (including individual condominium or cooperative units).

c. Use code 3 if the property to which the loan relates is a multifamily dwelling; is not located in an MSA; or is located in an MSA in which your institution has neither a home nor a branch office.

d. For purchased loans, you may assume that the property will be owner-occupied as a principal dwelling (code 1) unless the loan documents or application contain information to the contrary.

8. *Loan amount.* Enter the amount of the loan or application. Do not report loans below $500. Show the amount in thousands, rounding to the nearest thousand ($500 should be rounded up to the next $1,000). For example, a loan for $167,300 should be entered as 167 and one for $15,500 as 16.

a. For home-purchase loans that you originate, enter the principal amount of the loan as the loan amount. For home-purchase loans that you purchase, enter the unpaid principal balance of the loan at the time of purchase as the loan amount.

b. For home-improvement loans (both originations and purchases), you may include unpaid finance charges in the loan amount if that is how you record such loans on your books. For a multiple-purpose loan classified by you as a home-improvement loan because it involves a home-improvement purpose, enter the full amount of the loan, not just the amount specified for home improvement.

c. For home-equity lines of credit (if you have chosen to report them), enter as the loan amount only that portion of the line that is for home improvement. Report the loan amount for applications that did not result in originations in the same manner. Report only in the year the line is established.

d. For refinancings of dwelling-secured loans, indicate the total amount of the refinancing, including the amount outstanding on the original loan and the amount of new money (if any).

e. For a loan application that was denied or withdrawn, enter the amount applied for.

f. If you make a counteroffer for an amount different from the amount initially applied for, and the counteroffer is accepted by the applicant, report it as an origination for the amount of the loan actually granted. If the applicant turns down the counteroffer or fails to respond, report it as a denial for the amount initially requested.

B. *Action taken*

1. *Type of action.* Indicate the type of action taken on the application or loan by using one of the following codes. Do not report any loan application still pending at the end of the calendar year. You will report that application on your register for the year in which final action is taken.

1—Loan originated
2—Application approved but not accepted
3—Application denied
4—Application withdrawn
5—File closed for incompleteness
6—Loan purchased by your institution

2. *Explanation of codes.*

a. Use code 1 for a loan that is originated, including one resulting from a counteroffer (your offer to the applicant to make the loan on different terms or in a different amount than initially applied for) that the applicant accepts.

b. Use code 2 when an application is approved but the applicant (or a loan broker or correspondent) fails to respond to your notification of approval or your commitment letter within the specified time.

c. Use code 3 when an application is denied. This includes the situation when an applicant turns down or fails to respond to your counteroffer. Do *not* report as a withdrawn application or as an application that was approved but not accepted.

d. Use code 4 only when an application is expressly withdrawn by the applicant before a credit decision was made.

e. Use code 5 if you sent a written notice of incompleteness under section 202.9(c)(2) of Regulation B (Equal Credit Opportunity) and the applicant failed to respond to your request for additional information within the period of time specified in your notice.

3. *Date of action.* Enter the date by month, day, and year, using numerals in the form MM/DD/YY (for example, 02/22/92).

a. For loans originated, enter the settlement or closing date. For loans purchased, enter the date of purchase by your institution.

b. For applications denied, applications approved but not accepted by the applicant, and files closed for incompleteness, enter the date that the action was taken by your institution or the date the notice was sent to the applicant.

c. For applications withdrawn, enter the date you received the applicant's express withdrawal; or you may enter the date shown on the notification from the applicant, in the case of a written withdrawal.

C. *Property location.* In these columns enter the applicable codes for the MSA, state, county, and census tract for the property to which a loan relates. For home-purchase loans secured by one dwelling, but made for the purpose of purchasing another dwelling, report the property location for the property in which the security interest is to be taken. If the home-purchase loan is secured by more than one property, report the location data for the property being purchased. (See paragraphs 5, 6, and 7 of paragraph V.C. of this appendix for treatment of loans on property outside the MSAs in which you have offices.)

1. *MSA.* For each loan or loan application, indicate the location of the property by the MSA number. Enter only the MSA number, not the MSA name. MSA boundaries are defined by the U.S. Office of Management and Budget; use the boundaries that were in effect on January 1 of the calendar year for which you are reporting. A listing of MSAs is available from your regional supervisory agency or the FFIEC. (In these instructions, the term MSA refers to both metropolitan statistical area and primary metropolitan statistical area.)

2. *State and county.* You must use the Federal Information Processing Standard (FIPS) two-digit numerical code for the state and the three-digit numerical code for the county. These codes are available from your regional supervisory agency or the FFIEC. Do not use the letter abbreviations used by the U.S. Postal Service.

3. *Census tract.* Indicate the census tract where the property is located.

a. Enter the code "NA" if the property is located in an area not divided into census tracts on the U.S. Census Bureau's census-tract outline maps (see paragraph 4 below).

b. If the property is located in a county with a population of 30,000 or less in the 1990 census (as determined by the Census Bureau's 1990 CPH-2 population series), enter "NA" (even if the population has increased above 30,000 since 1990), or you may enter the census tract number.

4. *Census-tract number.* For the census-tract number, consult the U.S. Census Bureau's Census Tract/Street Index for 1990, and for addresses not listed in the index, consult the Census Bureau's census-tract outline maps. You must use the maps from the Census Bureau's 1990 CPH-3 series, or equivalent 1990 census data from the Census Bureau (such as the Census TIGER/Line File) or from a private publisher.

5. *Outside MSA.* For loans on property located outside the MSAs in which you have a home or branch office (or outside any MSA), you have two options. Under option 1, you may enter the MSA, state, and county codes and the census tract number. You may enter "NA" in the MSA or census tract column if no code or number exists for the property. (Codes exist for all states and counties.) If you choose option 1, the codes and tract number must accurately identify the location for the property in question. Under option 2, you may enter "NA" in all four columns, whether or not the codes or number exist for the property.

6. *Nondepository lenders.* If you are a for-profit mortgage lending institution (other than a bank, savings association, or credit union), and in the preceding calendar year you received applications for, or originated or purchased, loans for home purchase or home improvement adding up to a total of five or more for a given MSA, you are deemed to have a branch office in that MSA, whether or not you have a physical office there. As a result, you will have to enter the MSA, state, county, and censustract numbers for any transactions in that MSA. Because you must keep accurate records about lending within MSAs in the current calendar year in order to report data accurately the following year, to comply with this rule you may find it easier to enter the geographic information routinely for any property located within any MSA.

7. *Data reporting under CRA for banks and savings associations with total assets of $250 million or more and banks and savings associations that are subsidiaries of a holding company whose total banking and thrift assets are $1 billion or more.* If you are a bank or savings association with total assets of $250 millon or more as of December 31 for each of the immediately preceding two years, you must also enter the location of property located outside the MSAs in which you have a home or branch office, or outside any MSA. You must also enter this information if you are a bank or savings association that is a subsidiary of a holding company with total banking and thrift assets of $1 billion or more as of December 31 for each of the immediately preceding two years.

D. *Applicant information—race or national origin, sex, and income.* Appendix B of Regulation C contains instructions for the collection of data on race or national origin and sex, and also contains a sample form for data collection. The form is substantially similar to the form prescribed by section 202.13 of Regulation B (Equal Credit Opportunity) and contained in appendix B to that regulation. You may use either form.

1. *Applicability.* You must report this applicant information for loans that you originate as well as for applications that do not result in an origination.

a. You need not collect or report this information for loans purchased. If you choose not to, enter the codes specified in paragraphs 3, 4, and 5 below for "not applicable."

b. If your institution is a bank, savings association, or credit union that had assets of $30 million or less on the preceding December 31, you may—but need not—collect and report these data. If you choose not to, enter the codes specified in paragraphs 3, 4, and 5 below for "not applicable."

c. If the borrower or applicant is not a natural person (a corporation or partnership, for example), use the codes specified in paragraphs 3, 4, and 5 below for "not applicable."

2. *Mail and telephone applications.* Any loan applications mailed to applicants must contain a collection form similar to that shown in appendix B, and you must record on your register the data on race or national origin and sex if the applicant provides it. If the applicant chooses not to provide the data, enter the code for "information not provided by applicant in mail or telephone application" specified in paragraphs 3 and 4 below. If an application is taken entirely by telephone, you need not request this information. (See appendix B for complete information on the collection of this data in mail or telephone applications.)

3. *Race or national origin of borrower or applicant.* Use the following codes to indicate the race or national origin of the applicant or borrower under column "A" and of any co-applicant or co-borrower under column "CA." If there is more than one co-applicant, provide this information only for the first co-applicant listed on the application form. If there are no co-applicants or co-borrowers, enter code 8 for "not applicable" in the co-applicant column.

1—American Indian or Alaskan Native
2—Asian or Pacific Islander
3—Black
4—Hispanic
5—White

6—Other
7—Information not provided by applicant in mail or telephone application
8—Not applicable

4. *Sex of borrower or applicant.* Use the following codes to indicate the sex of the applicant or borrower under column "A" and of any co-applicant or co-borrower under column "CA." If there is more than one co-applicant, provide this information only for the first co-applicant listed on the application form. If there are no co-applicants or co-borrowers, enter code 4 for "not applicable."

1—Male
2—Female
3—Information not provided by applicant in mail or telephone application
4—Not applicable

5. *Income.* Enter the gross annual income that your institution relied upon in making the credit decision.

a. Round all dollar amounts to the nearest thousand (round $500 up to the next $1,000), and show in terms of thousands. For example, $35,500 should be reported as 36.

b. For loans on multifamily dwellings, enter "NA."

c. If no income information is asked for or relied on in the credit decision, enter "NA."

E. *Type of purchaser*

1. Enter the applicable code to indicate whether a loan that your institution originated or purchased was then sold to a secondary market entity within the same calendar year:

0—Loan was not originated or was not sold in calendar year covered by register
1—FNMA (Federal National Mortgage Association)
2—GNMA (Government National Mortgage Association)
3—FHLMC (Federal Home Loan Mortgage Corporation)
4—FmHA (Farmers Home Administration)
5—Commercial bank
6—Savings bank or savings association
7—Life insurance company
8—Affiliate institution
9—Other type of purchaser

2. *Explanation of codes*

a. Enter the code 0 for applications that were denied, withdrawn, or approved but not accepted by the applicant; and for files closed for incompleteness.

b. If you originated or purchased a loan and did not sell it during that same calendar year, enter the code 0. If you sell the loan in a succeeding year, you need not report the sale.

c. If you conditionally assign a loan to GNMA in connection with a mortgage-backed security transaction, use code 2.

d. Loans "swapped" for mortgage-backed securities are to be treated as sales; enter the type of entity receiving the loans that are swapped as the purchaser.

e. Use code 8 for loans sold to an institution affiliated with you, such as your subsidiary or a subsidiary of your parent corporation.

F. *Reasons for denial*

1. You are not required to enter the reasons for the denial of an application. But if you choose to do so, you may indicate up to three reasons by using the following codes:

1—Debt-to-income ratio
2—Employment history
3—Credit history
4—Collateral
5—Insufficient cash (downpayment, closing costs)
6—Unverifiable information
7—Credit application incomplete
8—Mortgage insurance denied
9—Other

2. Leave this column blank if the "action taken" on the application is not a denial. For example, do not complete this column if the application was withdrawn or the file was closed for incompleteness.

3. If your institution uses the model form for adverse action contained in the appendix

to Regulation B (Form C-1 in appendix C, Sample Notification Form, which offers some 20 reasons for denial), the following list shows which codes to enter.

a. *Code 1 corresponds to:* Income insufficient for amount of credit requested, and Excessive obligations in relation to income.

b. *Code 2 corresponds to:* Temporary or irregular employment, and Length of employment.

c. *Code 3 corresponds to:* Insufficient number of credit references provided; Unacceptable type of credit references provided; No credit file; Limited credit experience; Poor credit performance with us; Delinquent past or present credit obligations with others; Garnishment, attachment, foreclosure, repossession, collection action, or judgment; and Bankruptcy.

d. *Code 4 corresponds to:* Value or type of collateral not sufficient.

e. *Code 6 corresponds to:* Unable to verify credit references, Unable to verify employment, Unable to verify income, and Unable to verify residence.

f. *Code 7 corresponds to:* Credit application incomplete.

g. *Code 9 corresponds to:* Length of residence, Temporary residence, and Other reasons specified on notice.

VI. Federal Supervisory Agencies

Send your loan/application register and direct any questions to the office of your federal supervisory agency as specified below. If you are the nondepository subsidiary of a bank, savings association, or credit union, send the register to the supervisory agency for your parent institution. Terms that are not defined in the Federal Deposit Insurance Act (12 USC 1813(s)) shall have the meaning given to them in the International Banking Act of 1978 (12 USC 3101).

A. *National banks and their subsidiaries and federal branches and federal agencies of foreign banks.* District office of the Office of the Comptroller of the Currency for the district in which the institution is located.

B. *State member banks of the Federal Reserve System, their subsidiaries, subsidiaries of bank holding companies, branches and agencies of foreign banks (other than federal branches, federal agencies, and insured state branches of foreign banks), commercial lending companies owned or controlled by foreign banks, and organizations operating under sec tion 25 or 25A of the Federal Reserve Act.* Federal Reserve Bank serving the District in which the state member bank is located; for institutions other than state member banks, the Federal Reserve Bank specified by the Board of Governors.

C. *Nonmember insured banks (except for federal savings banks) and their subsidiaries and insured state branches of foreign banks.* Regional director of the Federal Deposit Insurance Corporation for the region in which the institution is located.

D. *Savings institutions insured under the Savings Association Insurance Fund of the FDIC, federally chartered savings banks insured under the Bank Insurance Fund of the FDIC (but not including state-chartered savings banks insured under the Bank Insurance Fund), their subsidiaries, and subsidiaries of savings institution holding companies.* Regional or other office specified by the Office of Thrift Supervision.

E. *Credit unions.* National Credit Union Administration, Office of Examination and Insurance, 1776 G Street, N.W., Washington, D.C. 20456.

F. *Other depository institutions.* Regional director of the Federal Deposit Insurance Corporation for the region in which the institution is located.

G. *Other mortgage-lending institutions.* Assistant Secretary for Housing, HMDA Reporting—Room 9233, U.S. Department of Housing and Urban Development, 451 7th Street, S.W., Washington, D.C. 20410.

Form FR HMDA-LAR.
OMB No. 7100-0247. Approval expires May 31, 2000.

LOAN/APPLICATION REGISTER

TRANSMITTAL SHEET

You must complete this transmittal sheet (please type or print) and attach it to the Loan/Application Register, required by the Home Mortgage Disclosure Act, that you submit to your supervisory agency.

Reporter's Identification Number	Agency Code	Reporter's Tax Identification Number	Total line entries contained in attached Loan/Application Register
_ _ _ _ _ _ _ _ _ _	– _	_ _ – _ _ _ _ _ _ _	______

The Loan/Application Register that is attached covers activity during the year _____ and contains a total of _____ pages.

Enter the name and address of your institution. The disclosure statement that is produced by the Federal Financial Institutions Examination Council will be mailed to the address you supply below:

____
Name of Institution

____
Address

____
City, State, ZIP

Enter the name, telephone number, and facsimile number of a person who may be contacted about questions regarding your register:

______________	( ) ______________	( ) ______________
Name	Telephone Number	Facsimile Number (if applicable)

If your institution is a subsidiary of another institution or corporation, enter the name of your parent:

____
Name

____
Address

____
City, State, ZIP

An officer of your institution must complete the following section.

I certify to the accuracy of the data contained in this register.

______________	______________	________
Name of Officer	Signature	Date

LOAN/APPLICATION REGISTER Page ____ of ____

Form FR HMDA-LAR

Reporter's Identification Number ______________ - ____ Agency Code

Name of Reporting Institution ______________ City, State, ZIP ______________

All columns (except Reasons for Denial) must be completed for each entry. See the instructions for details.

Application or Loan Information						Action Taken		Property Location				Applicant Information A = Applicant CA = Co-Applicant							
												Race or National Origin		Sex					
Application or Loan Number	Date Application Received (mm/dd/yy)	Type	Purpose	Owner Occupancy	Loan amount in thousands	Type	Date (mm/dd/yy)	Four-Digit MSA Number	Two-Digit State Code	Three-Digit County Code	Six-Digit Census Tract	A	CA	A	CA	Gross Annual Income in thousands	Type of Purchaser of Loan	Reasons for Denial (Optional)
Example of Loan Originated																		
LB-687439	01/15/92	2	1	1	65	1	02/22/92	8840	51	059	4219.85	3	8	1	4	24	7	
Example of Application Denied																		
0123456789-9876543210	03/20/92	1	1	1	125	3	04/30/92	0450	01	015	0021.00	5	4	2	1	55	0	4 1 5
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Loan/Application Register Code Sheet

Use the following codes to complete the loan/application register. The instructions to the HMDA-LAR explain the proper use of each code.

Application or Loan Information

Type:

1—Conventional (any loan other than FHA, VA or FmHA loans)
2—FHA-insured (Federal Housing Administration)
3—VA-guaranteed (Veterans Administration)
4—FmHA-insured (Farmers Home Administration)

Purpose:

1—Home purchase (one- to four-family)
2—Home improvement (one- to four-family)
3—Refinancing (home purchase or home improvement, one- to four-family)
4—Multifamily dwelling (home purchase, home improvement, and refinancings)

Owner Occupancy:

1—Owner-occupied as a principal dwelling
2—Not owner-occupied
3—Not applicable

Action Taken:

1—Loan originated
2—Application approved but not accepted
3—Application denied by financial institution
4—Application withdrawn by applicant
5—File closed for incompleteness
6—Loan purchased by your institution

Applicant Information

Race or National Origin:

1—American Indian or Alaskan Native
2—Asian or Pacific Islander
3—Black
4—Hispanic
5—White
6—Other
7—Information not provided by applicant in mail or telephone application
8—Not applicable

Sex:

1—Male
2—Female
3—Information not provided by applicant in mail or telephone application
4—Not applicable

Type of Purchaser

0—Loan was not sold in calendar year covered by register
1—FNMA (Federal National Mortgage Association)
2—GNMA (Government National Mortgage Association)
3—FHLMC (Federal Home Loan Mortgage Corporation)
4—FmHA (Farmers Home Administration)
5—Commercial bank
6—Savings bank or savings association
7—Life insurance company
8—Affiliate institution
9—Other type of purchaser

Reasons for Denial (optional)

1—Debt-to-income ratio
2—Employment history
3—Credit history
4—Collateral
5—Insufficient cash (downpayment, closing costs)
6—Unverifiable information
7—Credit application incomplete
8—Mortgage insurance denied
9—Other

APPENDIX B—Form and Instructions for Data Collection on Race or National Origin and Sex

I. *Instructions on Collection of Data on Race or National Origin and Sex*

A. *Format.* You may list questions regarding the race or national origin and sex of the applicant on your loan application form, or on a separate form that refers to the application. (See the sample form below for recommended language.)

B. *Procedures*

1. You must ask for this information, but cannot require the applicant to provide it.
2. If the applicant chooses not to provide the information for an application taken in person, note this fact on the form and note the data, to the extent possible, on the basis of visual observation or surname.
3. Inform the applicant that the federal government is requesting this information in order to monitor compliance with federal statutes that prohibit lenders from discriminating against applicants on these bases. Inform the applicant that if the information is not provided where the application is taken in person, you are required to note the data on the basis of visual observation or surname.
4. If an application is made entirely by telephone, you need not request this information. And you need not provide the data when you take an application by mail, if the applicant fails to answer these questions on the application form. You should indicate whether an application was received by mail or telephone, if it is not otherwise evident on the face of the application.
5. The "other" block is available only to the applicant who chooses to indicate some other appropriate category for race or national origin. If completing the form based on visual observation, do not use this category; use one of the other five categories.

Sample Data-Collection Form

INFORMATION FOR GOVERNMENT MONITORING PURPOSES

The following information is requested by the federal government for certain types of loans related to a dwelling in order to monitor the lender's compliance with equal credit opportunity, fair housing, and home mortgage disclosure laws. You are not required to furnish this information, but are encouraged to do so. The law provides that a lender may not discriminate on the basis of this information, or on whether you choose to furnish it. However, if you choose not to furnish the information and you have made this application in person, under federal regulations the lender is required to note race or national origin and sex on the basis of visual observation or surname. If you do not wish to furnish the information, please check below.

APPLICANT:

☐ I do not wish to furnish this information.

Race or National Origin:

☐ American Indian, Alaskan Native
☐ Asian, Pacific Islander
☐ Black
☐ Hispanic
☐ White
☐ Other (specify)____________________

Sex:

☐ Female
☐ Male

CO-APPLICANT:

☐ I do not wish to furnish this information.

Race or National Origin:

☐ American Indian, Alaskan Native
☐ Asian, Pacific Islander
☐ Black
☐ Hispanic
☐ White
☐ Other (specify)____________________

Sex:

☐ Female
☐ Male

Home Mortgage Disclosure Act

12 USC 2801 et seq.; 89 Stat. 1125; Pub. L. 94-200, Title III (December 31, 1975)

Section

SECTION 301—Short Title

This title may be cited as the "Home Mortgage Disclosure Act of 1975."

[12 USC 2801 note.]

SECTION 302—Findings and Purposes

(a) The Congress finds that some depository institutions have sometimes contributed to the decline of certain geographic areas by their failure pursuant to their chartering responsibilities to provide adequate home financing to qualified applicants on reasonable terms and conditions.

(b) The purpose of this title is to provide the citizens and public officials of the United States with sufficient information to enable them to determine whether depository institutions are filling their obligations to serve the housing needs of the communities and neighborhoods in which they are located and to assist public officials in their determination of the distribution of public sector investments in a manner designed to improve the private investment environment.

(c) Nothing in this title is intended to, nor shall it be construed to, encourage unsound lending practices or the allocation of credit.

[12 USC 2801.]

SECTION 303—Definitions

For purposes of this title—

(1) the term "mortgage loan" means a loan which is secured by residential real property or a home improvement loan;

(2) the term "depository institution"—

(A) means—

(i) any bank (as defined in section 3(a)(1) of the Federal Deposit Insurance Act);

(ii) any savings association (as defined in section 3(b)(1) of the Federal Deposit Insurance Act); and

(iii) any credit union,

which makes federally related mortgage loans as determined by the Board; and

(B) includes any other lending institution (as defined in paragraph (4)) other than any institution described in subparagraph (A);

(3) the term "completed application" means an application in which the creditor has received the information that is regularly obtained in evaluating applications for the amount and type of credit requested;

(4) the term "other lending institutions" means any person engaged for profit in the business of mortgage lending;

(5) the term "Board" means the Board of Governors of the Federal Reserve System; and

(6) the term "Secretary" means the Secretary of Housing and Urban Development.

[12 USC 2802. As amended by acts of Feb. 5, 1988 (101 Stat. 1945) and Aug. 9, 1989 (103 Stat. 525).]

SECTION 304—Maintenance of Records and Public Disclosure

(a) (1) Each depository institution which has a home office or branch office located within a primary metropolitan statistical area, metropolitan statistical area, or consolidated metropolitan statistical area that is not comprised of designated primary metropolitan statistical areas, as defined by the Department of Commerce shall compile and make available, in accordance with regulations of the Board, to the public for inspection and copying at the home office, and at least one branch office within each primary metropolitan statistical area, metropolitan statistical area, or consolidated metropolitan statistical area that is not comprised of designated primary metropolitan statistical areas in which the depository institution has an office the number and total dollar amount of mortgage loans which were (A) originated (or for which the institution received completed applications), or (B) purchased by that institution during each fiscal year (beginning with the last full fiscal year of that institution which immediately preceded the effective date of this title.)

(2) The information required to be maintained and made available under paragraph (1) shall also be itemized in order to clearly and conspicuously disclose the following:

(A) The number and dollar amount for each item referred to in paragraph (1), by census tracts for mortgage loans secured by property located within any county with a population of more than 30,000, within that primary metropolitan statistical area, metropolitan statistical area, or consolidated metropolitan statistical area that is not comprised of designated primary metropolitan statistical areas, otherwise, by county, for mortgage loans secured by property located within any other county within that primary metropolitan statistical area, metropolitan statistical area, or consolidated metropolitan statistical area that is not comprised of designated primary metropolitan statistical areas.

(B) The number and dollar amount for each item referred to in paragraph (1) for all such mortgage loans which are secured by property located outside that primary metropolitan statistical area, metropolitan statistical area, or consolidated metropolitan statistical area that is not comprised of designated primary metropolitan statistical areas.

For the purpose of this paragraph, a depository institution which maintains offices in more than one primary metropolitan statistical area, metropolitan statistical area, or consolidated metropolitan statistical area that is not comprised of designated primary metropolitan statistical areas shall be required to make the information required by this paragraph available at any such office only to the extent that such information relates to mortgage loans which were originated or purchased (or for which completed applications were received) by an office of that depository institution located in the primary metropolitan statistical area, metropolitan statistical area, or consolidated metropolitan statistical area that is not comprised of designated primary metropolitan statistical areas in which the office making such information available is located. For purposes of this paragraph, other lending institutions shall be deemed to have a home office or branch office within a primary metropolitan statistical area, metropolitan statistical area, or consolidated metropolitan statistical area that is not comprised of designated primary metropolitan statistical areas if such institutions have originated or purchased or received completed applications for at least 5 mortgage loans in such area in the preceding calendar year.

(b) Any item of information relating to mortgage loans required to be maintained under subsection (a) shall be further itemized in order to disclose for each such item—

(1) the number and dollar amount of mortgage loans which are insured under title II of the National Housing Act or under title V of the Housing Act of 1949 or which are guaranteed under chapter 37 of title 38, United States Code;

(2) the number and dollar amount of mortgage loans made to mortgagors who did not, at the time of execution of the mortgage, intend to reside in the property securing the mortgage loan;

(3) the number and dollar amount of home improvement loans; and

(4) the number and dollar amount of mortgage loans and completed applications involving mortgagors or mortgage applicants grouped according to census tract, income level, racial characteristics, and gender.

(c) Any information required to be compiled and made available under this section, other than loan application register information under subsection (j), shall be maintained and made available for a period of five years after the close of the first year during which such information is required to be maintained and made available.

(d) Notwithstanding the provisions of subsection (a)(1), data required to be disclosed under this section for 1980 and thereafter shall be disclosed for each calendar year. Any depository institution which is required to make disclosures under this section but which has been making disclosures on some basis other than a calendar year basis shall make available a separate disclosure statement containing data for any period prior to calendar year 1980 which is not covered by the last full year report prior to the 1980 calendar year report.

(e) Subject to subsection (h), the Board shall prescribe a standard format for the disclosures required under this section.

(f) The Federal Financial Institutions Examination Council in consultation with the Secretary, shall implement a system to facilitate access to data required to be disclosed under this section. Such system shall include arrangements for a central depository of data in each primary metropolitan statistical area, metropolitan statistical area, or consolidated metropolitan statistical area that is not comprised of designated primary metropolitan statistical areas. Disclosure statements shall be made available to the public for inspection and copying at such central depository of data for all depository institutions which are required to disclose information under this section (or which are exempted pursuant to section 306(b)) and which have a home office or branch office within such primary metropolitan statistical area, metropolitan statistical area, or consolidated metropolitan statistical area that is not comprised of designated primary metropolitan statistical areas.

(g) The requirements of subsections (a) and (b) shall not apply with respect to mortgage loans that are—

(1) made (or for which completed applications are received) by any mortgage banking subsidiary of a bank holding company or savings and loan holding company or by any savings and loan service corporation that originates or purchases mortgage loans; and

(2) approved (or for which completed applications are received) by the secretary for insurance under title I or II of the National Housing Act.

(h) The data required to be disclosed under subsection (b)(4) shall be submitted to the appropriate agency for each institution reporting under this title. Notwithstanding the requirement of section 304(a)(2)(A) for disclosure by census tract, the Board, in cooperation with other appropriate regulators, including—

(1) the Office of the Comptroller of the Currency for national banks and Federal branches and Federal agencies of foreign banks;

(2) the Director of the Office of Thrift Supervision for savings associations;

(3) the Federal Deposit Insurance Corporation for banks insured by the Federal Deposit Insurance Corporation (other than members of the Federal Reserve System), mutual savings banks, insured State branches of foreign banks, and any other depository institution described in section 303(2)(A) which is not otherwise referred to in this paragraph;

(4) the National Credit Union Administration Board for credit unions; and

(5) the Secretary of Housing and Urban Development for other lending institutions not regulated by the agencies referred to in paragraphs (1) through (4),

shall develop regulations prescribing the format for such disclosures, the method for submission of the data to the appropriate regulatory agency, and the procedures for disclosing the information to the public. These regulations shall also require the collection of data required to be disclosed under subsection (b)(4) with respect to loans sold by each institution reporting under this title, and, in addition, shall require disclosure of the class of the purchaser of such loans. Any reporting institution may submit in writing to the appropriate agency such additional data or explanations as it deems relevant to the decision to originate or purchase mortgage loans.

(i) The requirements of subsection (b)(4) shall not apply with respect to any depository institution described in section 303(2)(A) which has total assets, as of the most recent full fiscal year of such institution, of $30,000,000 or less.

(j) *Loan application register information.*

(1) In addition to the information required to be disclosed under subsections (a) and (b), any depository institution which is required to make disclosures under this section shall make available to the public, upon request, loan application register information (as defined by the Board by regulation) in the form required under regulations prescribed by the Board.

(2) (A) Subject to subparagraph (B), the loan application register information described in paragraph (1) may be disclosed by a depository institution without editing or compilation and in the format in which such information is maintained by the institution.

(B) The Board shall require, by regulation, such deletions as the Board may determine to be appropriate to protect—

(i) any privacy interest of any applicant, including the deletion of the applicant's name and identification number, the date of the application, and the date of any determination by the institution with respect to such application; and

(ii) a depository institution from liability under any Federal or State privacy law.

(C) It is the sense of the Congress that a depository institution should provide loan register information under this section in a format based on the census tract in which the property is located.

(3) A depository institution meets the disclosure requirement of paragraph (1) if the institution provides the information required under such paragraph in the form in which the institution maintains such information.

(4) Any depository institution which provides information under this subsection may impose a reasonable fee for any cost incurred in reproducing such information.

(5) The disclosure of the loan application register information described in paragraph (1) for any year pursuant to a request under paragraph (1) shall be made—

(A) in the case of a request made on or before March 1 of the succeeding year, before April 1 of the succeeding year; and

(B) in the case of a request made after March 1 of the succeeding year, before the end of the 30-day period beginning on the date the request is made.

(6) Notwithstanding subsection (c), the loan application register information described in paragraph (1) for any year shall be maintained and made available, upon request, for 3 years after the close of the 1st year during which such information is required to be maintained and made available.

(7) In prescribing regulations under this subsection, the Board shall make every effort to minimize the costs incurred by a depository institution in complying with this subsection and such regulations.

(k) *Disclosure of statements by depository institutions.*

(1) In accordance with procedures established by the Board pursuant to this section, any depository institution required to make disclosures under this section—

(A) shall make a disclosure statement available, upon request, to the public no later than 3 business days after the institution receives the statement from the Federal Financial Institutions Examination Council; and

(B) may make such statement available on a floppy disc which may be used with a personal computer or in any other media which is not prohibited under regulations prescribed by the Board.

(2) Any disclosure statement provided pursuant to paragraph (1) shall be accompanied by a clear and conspicuous notice that the statement is subject to final review and revision, if necessary.

(3) Any depository institution which provides a disclosure statement pursuant to paragraph (1) may impose a reasonable fee for any cost incurred in providing or reproducing such statement.

(l) *Prompt disclosures.*

(1) Any disclosure of information pursuant to this section or section 310 shall be made as promptly as possible.

(2) (A) Except as provided in subsections (j)(5) and (k)(1) and regulations prescribed by the Board and subject to subparagraph (B), any information required to be disclosed for any year beginning after December 31, 1992, under—

(i) this section shall be made available to the public before September 1 of the succeeding year; and

(ii) section 310 shall be made available to the public before December 1 of the succeeding year.

(B) With respect to disclosures of information under this section or section 310 for any year beginning after December 31, 1993, every effort shall be made—

(i) to make information disclosed under this section or section 310 available to the public before July 1 of the succeeding year; and

(ii) to make information required to be disclosed under section 310 available to the public before September 1 of the succeeding year.

(3) The Federal Financial Institutions Examination Council shall make such changes in the system established pursuant to subsection (f) as may be necessary to carry out the requirements of this subsection.

(m) *Opportunity to reduce compliance burden.*

(1) (A) A depository institution shall be deemed to have satisfied the public availability requirements of subsection (a) if the institution compiles the information required under that subsection at the home office of the institution and provides notice at the branch locations specified in subsection (a) that such information is available from the home office of the institution upon written request.

(B) Not later than 15 days after the receipt of a written request for any information required to be compiled under subsection (a), the home office of the depository institution receiving the request shall provide the information pertinent to the location of the branch in question to the person requesting the information.

(2) In complying with paragraph (1), a depository institution shall, in the sole discretion of the institution, provide the person requesting the information with—

(A) a paper copy of the information requested; or

(B) if acceptable to the person, the information through a form of electronic medium, such as a computer disk.

[12 USC 2803. As amended by acts of Oct. 8, 1980 (94 Stat. 1657); Nov. 30, 1983 (97 Stat. 1266); Feb. 5, 1988 (101 Stat. 1945, 1950); Aug. 9, 1989 (103 Stat. 524, 525, 526); Dec. 19, 1991 (105 Stat. 2299); Oct. 28, 1992 (106 Stat. 3889, 3891); and Sept. 30, 1996 (110 Stat. 3009-416).]

SECTION 305—Enforcement

(a) The Board shall prescribe such regulations as may be necessary to carry out the purposes of this title. These regulations may contain such classifications, differentiations, or other provisions, and may provide for such adjustments and exceptions for any class of transactions, as in the judgment of the Board are necessary and proper to effectuate the purposes of this title, and prevent circumvention or evasion thereof, or to facilitate compliance therewith.

(b) Compliance with the requirements imposed under this title shall be enforced under—

(1) section 8 of the Federal Deposit Insurance Act, in the case of—

(A) national banks and Federal branches and Federal agencies of foreign banks, by the Office of Comptroller of the Currency;

(B) member banks of the Federal Reserve System (other than national banks), branches and agencies of foreign banks (other than Federal branches, Federal agencies, and insured State branches of foreign banks), commercial lending companies owned or controlled by foreign banks, and organizations operating under section 25 or 25A of the Federal Reserve Act, by the Board; and

(C) banks insured by the Federal Deposit Insurance Corporation (other than members of the Federal Reserve System), mutual savings banks as defined in section 3(f) of the Federal Deposit Insurance Act (12 U.S.C. 1813(f)), insured State branches of foreign banks, and any other depository institution not referred to in this paragraph or paragraph (2) or (3) of this subsection, by the Board of Directors of the Federal Deposit Insurance Corporation;

(2) section 8 of the Federal Deposit Insurance Act, by the Director of the Office of Thrift Supervision, in the case of a savings association the deposits of which are insured by the Federal Deposit Insurance Corporation;

(3) the Federal Credit Union Act, by the Administrator of the National Credit Union Administration with respect to any credit union; and

(4) other lending institutions, by the Secretary of Housing and Urban Development.

The terms used in paragraph (1) that are not defined in this title or otherwise defined in section 3(s) of the Federal Deposit Insurance Act (12 U.S.C. 1813(s)) shall have the meaning given to them in section 1(b) of the International Banking Act of 1978 (12 U.S.C. 3101).

(c) For the purpose of the exercise by any agency referred to in subsection (b) of its powers under any Act referred to in that subsection, a violation of any requirement imposed under this title shall be deemed to be a violation of a requirement imposed under that Act. In addition to its powers under any provision of law specifically referred to in subsection (b), each of the agencies referred to in that subsection may exercise, for the purpose of enforcing compliance with any requirement imposed under this title, any other authority conferred on it by law.

[12 USC 2804. As amended by acts of Aug. 9, 1989 (103 Stat. 440, 526) and Dec. 19, 1991 (105 Stat. 2299).]

SECTION 306—Relation to State Laws

(a) This title does not annul, alter, or affect, or exempt any State-chartered depository institution subject to the provisions of this title from complying with the laws of any state or subdivision thereof with respect to public disclosure and recordkeeping by depository institutions, except to the extent that those laws are inconsistent with any provision of this title, and then only to the extent of the inconsistency. The Board is authorized to determine whether such inconsistencies exist. The Board may not determine that any such law is inconsistent with any provision of this title if the Board determines that such law requires the maintenance of records with greater geographic or other detail than is required under this title, or that such law otherwise provides greater disclosure than is required under this title.

(b) The Board may by regulation exempt from the requirements of this title any state-chartered depository institution within any state or subdivision thereof if it determines that, under the law of such state or subdivision, that institution is subject to requirements substantially similar to those imposed under this title, and that such law contains adequate provisions for enforcement. Notwithstanding any other provision of this subsection, compliance with the requirements imposed under this subsection shall be enforced under—

(1) section 8 of the Federal Deposit Insurance Act in the case of national banks, by the Comptroller of the Currency; and

(2) section 8 of the Federal Deposit Insurance Act, by the Director of the Office of Thrift Supervision in the case of a savings association the deposits of which are insured by the Federal Deposit Insurance Corporation.

[12 USC 2805. As amended by act of Aug. 9, 1989 (103 Stat. 440).]

SECTION 307—Research and Improved Methods

(a) (1) The Director of the Office of Thrift Supervision, with the assistance of the Secretary, the Director of the Bureau of the Census, the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and such other persons as the

Director of the Office of Thrift Supervision deems appropriate, shall develop, or assist in the improvement of, methods of matching addresses and census tracts to facilitate compliance by depository institutions in as economical a manner as possible with the requirements of this title.

(2) There is authorized to be appropriated such sums as may be necessary to carry out this subsection.

(3) The Director of the Office of Thrift Supervision is authorized to utilize, contract with, act through, or compensate any person or agency in order to carry out this subsection.

(b) The Director of the Office of Thrift Supervision shall recommend to the Committee on Banking, Finance and Urban Affairs of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate such additional legislation as the Director of the Office of Thrift Supervision deems appropriate to carry out the purpose of this title.

[12 USC 2806. As amended by H. Res. 5 of Jan. 4, 1977 and acts of Nov. 7, 1988 (102 Stat. 3280) and Aug. 9, 1989 (103 Stat. 440).]

SECTION 308—Study

The Board, in consultation with the Secretary of Housing and Urban Development, shall report annually to the Congress on the utility of the requirements of section 304(b)(4).

[12 USC 2807. As amended by acts of Nov. 30, 1983 (97 Stat. 1266) and Aug. 9, 1989 (103 Stat. 526).]

SECTION 309—Effective Date

(a) *In general.* This title shall take effect on the one hundred and eightieth day beginning after the date of its enactment. Any institution specified in section 303(2)(A) which has total assets as of its last full fiscal year of $10,000,000 or less is exempt from the provisions of this title. The Board, in consultation with the Secretary, may exempt institutions described in section 303(2)(B) that are comparable within their respective industries to institutions that are exempt under the preceding sentence (as determined without regard to the adjustment made by subsedtion (b)).

(b) *CPI adjustments.*

(1) Subject to paragraph (2), the dollar amount applicable with respect to institutions described in section 303(2)(A) under the 2d sentence of subsection (a) shall be adjusted annually after December 31, 1996, by the annual percentage increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers published by the Bureau of Labor Statistics.

(2) The first adjustment made under paragraph (1) after the date of the enactment of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 shall be the percentage by which—

(A) the Consumer Price Index described in such paragraph for the calendar year 1996, exceeds

(B) such Consumer Price Index for the calendar year 1975.

(3) The dollar amount applicable under paragraph (1) for any calendar year shall be the amount determined in accordance with subparagraphs (A) and (B) of paragraph (2) and rounded to the nearest multiple of $1,000,000.

[12 USC 2808. As amended by acts of Dec. 19, 1991 (105 Stat. 2307) and Sept. 30, 1996 (110 Stat. 3009-415).]

SECTION 310—Compilation of Aggregate Data

(a) Beginning with data for calendar year 1980, the Federal Financial Institutions Examination Council shall compile each year, for each primary metropolitan statistical area, metropolitan statistical area, or consolidated metropolitan statistical area that is not comprised of designated primary metropolitan statistical areas, aggregate data by census tract for all depository institutions which are required to disclose data under section 304 or which are exempt pursuant to section 306(b). The Council shall also produce tables indicating, for each primary metropolitan statistical area, metropolitan statistical area, or consolidated metropolitan statistical area that is not comprised of designated primary metropolitan statistical areas, aggregate lending patterns for various categories of census tracts grouped according to location, age of housing stock, income level, and racial characteristics.

(b) The Board shall provide staff and data processing resources to the Council to enable it to carry out the provisions of subsection (a).

(c) The data and tables required pursuant to subsection (a) shall be made available to the public by no later than December 31 of the year following the calendar year on which the data is based.

[12 USC 2809. As added by act of Oct. 8, 1980 (94 Stat. 1658) and amended by act of Nov. 30, 1983 (97 Stat. 1266).]

SECTION 311—Disclosure by the Secretary

Beginning with data for calendar year 1980, the Secretary shall make publicly available data in the Secretary's possession for each mortgagee which is not otherwise subject to the requirements of this title and which is not exempt pursuant to section 306(b) (and for each mortgagee making mortgage loans exempted under section 304(g)), with respect to mortgage loans approved (or for which completed applications are received) by the Secretary for insurance under title I or II of the National Housing Act. Such data to be disclosed shall consist of data comparable to the data which would be disclosed if such mortgagee were subject to the requirements of section 304. Disclosure statements containing data for each such mortgage for a primary metropolitan statistical area, metropolitan statistical area, or consolidated metropolitan statistical area that is not comprised of designated primary metropolitan statistical areas shall, at a minimum, be publicly available at the central depository of data established pursuant to section 304(f) for such primary metropolitan statistical area, metropolitan statistical area, or consolidated metropolitan statistical area that is not comprised of designated primary metropolitan statistical areas. The Secretary shall also compile and make publicly available aggregate data for such mortgagees by census tract, and tables indicating aggregate lending patterns, in a manner comparable to the information required to be made publicly available in accordance with section 310.

[12 USC 2810. As added by act of Oct. 8, 1980 (94 Stat. 1658) and amended by acts of Nov. 30, 1983 (97 Stat. 1266); Feb. 5, 1988 (101 Stat. 1945); and Aug. 9, 1989 (103 Stat. 525).]

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(d) The Federal Financial Institutions Examination Council, in consultation with the Administrator of the Small Business Administration, shall conduct a study to assess the feasibility and usefulness of requiring depository institutions which make small business loans to compile and publicly disclose information regarding such loans. The Council shall submit a report on the results of such study, together with recommendations, to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Banking, Finance and Urban Affairs of the House of Representatives not later than March 1, 1981.

[12 USC 3305 note.]

(e) To promote efficiency and avoid duplication to the maximum extent feasible, the Federal Financial Institutions Examination Council shall transmit a report to the Congress not later than September 30, 1982, on the feasibility and desirability of establishing a unified system for enforcing fair lending laws and regulations, implementing the Community Reinvestment Act of 1977, and satisfying the public disclosure purposes of the Home Mortgage Disclosure Act of 1975. Such report shall evaluate the status and effectiveness of data collection and analysis systems of such agencies involving fair lending and community reinvestment, and shall outline possible specific timetables for implementing such a unified system.

[12 USC 3305 note.]

Board of Governors of the Federal Reserve System

Regulation M
Consumer Leasing

12 CFR 213; as amended effective April 1, 1997

Any inquiry relating to Regulation M should be addressed to the Federal Reserve Bank of the District in which the inquiry arises.

July 1997

Contents

TRUTH IN LENDING ACT

Regulation M
Consumer Leasing

12 CFR 213; as amended effective April 1, 1997*

SECTION 213.1—Authority, Scope, Purpose, and Enforcement

(a) *Authority.* The regulation in this part, known as Regulation M, is issued by the Board of Governors of the Federal Reserve System to implement the consumer leasing provisions of the Truth in Lending Act, which is title I of the Consumer Credit Protection Act, as amended (15 USC 1601 et seq.). Information-collection requirements contained in this regulation have been approved by the Office of Management and Budget under the provisions of 44 USC 3501 et seq. and have been assigned OMB control number 7100-0202.

(b) *Scope and purpose.* This part applies to all persons that are lessors of personal property under consumer leases as those terms are defined in section 213.2(e)(1) and (h). The purpose of this part is—

(1) to ensure that lessees of personal property receive meaningful disclosures that enable them to compare lease terms with other leases and, where appropriate, with credit transactions;

(2) to limit the amount of balloon payments in consumer lease transactions; and

(3) to provide for the accurate disclosure of lease terms in advertising.

(c) *Enforcement and liability.* Section 108 of the act contains the administrative enforcement provisions. Sections 112, 130, 131, and 185 of the act contain the liability provisions for failing to comply with the requirements of the act and this part.

SECTION 213.2—Definitions

For the purposes of this part the following definitions apply:

(a) *Act* means the Truth in Lending Act (15 USC 1601 et seq.) and the Consumer Leasing Act is chapter 5 of the Truth In Lending Act.

(b) *Advertisement* means a commercial message in any medium that directly or indirectly promotes a consumer lease transaction.

(c) *Board* refers to the Board of Governors of the Federal Reserve System.

(d) *Closed-end lease* means a consumer lease other than an open-end lease as defined in this section.

(e) (1) *Consumer lease* means a contract in the form of a bailment or lease for the use of personal property by a natural person primarily for personal, family, or household purposes, for a period exceeding four months and for a total contractual obligation not exceeding $25,000, whether or not the lessee has the option to purchase or otherwise become the owner of the property at the expiration of the lease. Unless the context indicates otherwise, in this part "lease" means "consumer lease."

(2) The term does not include a lease that meets the definition of a credit sale in Regulation Z (12 CFR 226.2(a)). It also does not include a lease for agricultural, business, or commercial purposes or a lease made to an organization.

(3) This part does not apply to a lease transaction of personal property which is incident to the lease of real property and which provides that—

(i) the lessee has no liability for the value of the personal property at the end of the lease term except for abnormal wear and tear, and

(ii) the lessee has no option to purchase the leased property.

(f) *Gross capitalized cost* means the amount agreed upon by the lessor and the lessee as the value of the leased property and any items that are capitalized or amortized during the lease term, including but not limited to taxes, insurance, service agreements, and any outstanding prior credit or lease balance. *Capitalized cost reduction* means the total amount of any rebate, cash payment, net trade-in allowance, and noncash credit that reduces the

* Compliance with the revised version is optional until October 1, 1997.

gross capitalized cost. The *adjusted capitalized cost* equals the gross capitalized cost less the capitalized cost reduction, and is the amount used by the lessor in calculating the base periodic payment.

(g) *Lessee* means a natural person who enters into or is offered a consumer lease.

(h) *Lessor* means a person who regularly leases, offers to lease, or arranges for the lease of personal property under a consumer lease. A person who has leased, offered, or arranged to lease personal property more than five times in the preceding calendar year or more than five times in the current calendar year is subject to the act and this part.

(i) *Open-end lease* means a consumer lease in which the lessee's liability at the end of the lease term is based on the difference between the residual value of the leased property and its realized value.

(j) *Organization* means a corporation, trust, estate, partnership, cooperative, association, or government entity or instrumentality.

(k) *Person* means a natural person or an organization.

(*l*) *Personal property* means any property that is not real property under the law of the state where the property is located at the time it is offered or made available for lease.

(m) *Realized value* means—

(1) the price received by the lessor for the leased property at disposition;

(2) the highest offer for disposition of the leased property; or

(3) the fair market value of the leased property at the end of the lease term.

(n) *Residual value* means the value of the leased property at the end of the lease term, as estimated or assigned at consummation by the lessor, used in calculating the base periodic payment.

(o) *Security interest* and *security* mean any interest in property that secures the payment or performance of an obligation.

(p) *State* means any state, the District of Columbia, the Commonwealth of Puerto Rico, and any territory or possession of the United States.

SECTION 213.3—General Disclosure Requirements

(a) *General requirements.* A lessor shall make the disclosures required by section 213.4, as applicable. The disclosures shall be made clearly and conspicuously in writing in a form the consumer may keep, in accordance with this section.

(1) *Form of disclosures.* The disclosures required by section 213.4 shall be given to the lessee together in a dated statement that identifies the lessor and the lessee; the disclosures may be made either in a separate statement that identifies the consumer lease transaction or in the contract or other document evidencing the lease. Alternatively, the disclosures required to be segregated from other information under paragraph (a)(2) of this section may be provided in a separate dated statement that identifies the lease, and the other required disclosures may be provided in the lease contract or other document evidencing the lease. In a lease of multiple items, the property description required by section 213.4(a) may be given in a separate statement that is incorporated by reference in the disclosure statement required by this paragraph.

(2) *Segregation of certain disclosures.* The following disclosures shall be segregated from other information and shall contain only directly related information: section 213.4(b) through (f), (g)(2), (h)(3), (i)(1), (j), and (m)(1). The headings, content, and format for the disclosures referred to in this paragraph (a)(2) shall be provided in a manner substantially similar to the applicable model form in appendix A of this part.

(3) *Timing of disclosures.* A lessor shall provide the disclosures to the lessee prior to the consummation of a consumer lease.

(4) *Language of disclosures.* The disclosures required by section 213.4 may be made in a language other than English provided that they are made available in English upon the lessee's request.

(b) *Additional information; nonsegregated disclosures.* Additional information may be provided with any disclosure not listed in paragraph (a)(2) of this section, but it shall not be stated, used, or placed so as to mislead or confuse the lessee or contradict, obscure, or detract attention from any disclosure required by this part.

(c) *Multiple lessors or lessees.* When a transaction involves more than one lessor, the disclosures required by this part may be made by one lessor on behalf of all the lessors. When a lease involves more than one lessee, the lessor may provide the disclosures to any lessee who is primarily liable on the lease.

(d) *Use of estimates.* If an amount or other item needed to comply with a required disclosure is unknown or unavailable after reasonable efforts have been made to ascertain the information, the lessor may use a reasonable estimate that is based on the best information available to the lessor, is clearly identified as an estimate, and is not used to circumvent or evade any disclosures required by this part.

(e) *Effect of subsequent occurrence.* If a required disclosure becomes inaccurate because of an event occurring after consummation, the inaccuracy is not a violation of this part.

(f) *Minor variations.* A lessor may disregard the effects of the following in making disclosures:

(1) that payments must be collected in whole cents;
(2) that dates of scheduled payments may be different because a scheduled date is not a business day;
(3) that months have different numbers of days; and
(4) that February 29 occurs in a leap year.

SECTION 213.4—Content of Disclosures

For any consumer lease subject to this part, the lessor shall disclose the following information, as applicable:

(a) *Description of property.* A brief description of the leased property sufficient to identify the property to the lessee and lessor.

(b) *Amount due at lease signing or delivery.* The total amount to be paid prior to or at consummation or by delivery, if delivery occurs after consummation, using the term "amount due at lease signing or delivery." The lessor shall itemize each component by type and amount, including any refundable security deposit, advance monthly or other periodic payment, and capitalized cost reduction; and in motor vehicle leases, shall itemize how the amount due will be paid, by type and amount, including any net trade-in allowance, rebates, noncash credits, and cash payments in a format substantially similar to the model forms in appendix A of this part.

(c) *Payment schedule and total amount of periodic payments.* The number, amount, and due dates or periods of payments scheduled under the lease, and the total amount of the periodic payments.

(d) *Other charges.* The total amount of other charges payable to the lessor, itemized by type and amount, that are not included in the periodic payments. Such charges include the amount of any liability the lease imposes upon the lessee at the end of the lease term; the potential difference between the residual and realized values referred to in paragraph (k) of this section is excluded.

(e) *Total of payments.* The total of payments, with a description such as "the amount you will have paid by the end of the lease." This amount is the sum of the amount due at lease signing (less any refundable amounts), the total amount of periodic payments (less any portion of the periodic payment paid at lease signing), and other charges under paragraphs (b), (c), and (d) of this section. In an open-end lease, a description such as "you will owe an additional amount if the actual value of the vehicle is less than the residual value" shall accompany the disclosure.

(f) *Payment calculation.* In a motor vehicle lease, a mathematical progression of how the scheduled periodic payment is derived, in a format substantially similar to the applicable model form in appendix A of this part, which shall contain the following:

(1) *Gross capitalized cost.* The gross capitalized cost, including a disclosure of the

agreed-upon value of the vehicle, a description such as "the agreed-upon value of the vehicle [state the amount] and any items you pay for over the lease term (such as service contracts, insurance, and any outstanding prior credit or lease balance)," and a statement of the lessee's option to receive a separate written itemization of the gross capitalized cost. If requested by the lessee, the itemization shall be provided before consummation.

(2) *Capitalized cost reduction.* The capitalized cost reduction, with a description such as "the amount of any net trade-in allowance, rebate, noncash credit, or cash you pay that reduces the gross capitalized cost."

(3) *Adjusted capitalized cost.* The adjusted capitalized cost, with a description such as "the amount used in calculating your base [periodic] payment."

(4) *Residual value.* The residual value, with a description such as "the value of the vehicle at the end of the lease used in calculating your base [periodic] payment."

(5) *Depreciation and any amortized amounts.* The depreciation and any amortized amounts, which is the difference between the adjusted capitalized cost and the residual value, with a description such as "the amount charged for the vehicle's decline in value through normal use and for any other items paid over the lease term."

(6) *Rent charge.* The rent charge, with a description such as "the amount charged in addition to the depreciation and any amortized amounts." This amount is the difference between the total of the base periodic payments over the lease term minus the depreciation and any amortized amounts.

(7) *Total of base periodic payments.* The total of base periodic payments with a description such as "depreciation and any amortized amounts plus the rent charge."

(8) *Lease term.* The lease term with a description such as "the number of [periods of repayment] in your lease."

(9) *Base periodic payment.* The total of the base periodic payments divided by the number of payment periods in the lease.

(10) *Itemization of other charges.* An itemization of any other charges that are part of the periodic payment.

(11) *Total periodic payment.* The sum of the base periodic payment and any other charges that are part of the periodic payment.

(g) *Early termination.*

(1) *Conditions and disclosure of charges.* A statement of the conditions under which the lessee or lessor may terminate the lease prior to the end of the lease term; and the amount or a description of the method for determining the amount of any penalty or other charge for early termination, which must be reasonable.

(2) *Early-termination notice.* In a motor vehicle lease, a notice substantially similar to the following: "Early Termination. You may have to pay a substantial charge if you end this lease early. *The charge may be up to several thousand dollars.* The actual charge will depend on when the lease is terminated. The earlier you end the lease, the greater this charge is likely to be."

(h) *Maintenance responsibilities.* The following provisions are required:

(1) *Statement of responsibilities.* A statement specifying whether the lessor or the lessee is responsible for maintaining or servicing the leased property, together with a brief description of the responsibility;

(2) *Wear-and-use standard.* A statement of the lessor's standards for wear and use (if any), which must be reasonable; and

(3) *Notice of wear-and-use standard.* In a motor vehicle lease, a notice regarding wear and use substantially similar to the following: "Excessive Wear and Use. You may be charged for excessive wear based on our standards for normal use." The notice shall also specify the amount or method for determining any charge for excess mileage.

(i) *Purchase option.* A statement of whether or not the lessee has the option to purchase the leased property, and:

(1) *End of lease term.* If at the end of the lease term, the purchase price; and

(2) *During lease term.* If prior to the end of the lease term, the purchase price or the method for determining the price and when the lessee may exercise this option.

(j) *Statement referencing nonsegregated dis-*

closures. A statement that the lessee should refer to the lease documents for additional information on early termination, purchase options and maintenance responsibilities, warranties, late and default charges, insurance, and any security interests, if applicable.

(k) *Liability between residual and realized values.* A statement of the lessee's liability, if any, at early termination or at the end of the lease term for the difference between the residual value of the leased property and its realized value.

(*l*) *Right of appraisal.* If the lessee's liability at early termination or at the end of the lease term is based on the realized value of the leased property, a statement that the lessee may obtain, at the lessee's expense, a professional appraisal by an independent third party (agreed to by the lessee and the lessor) of the value that could be realized at sale of the leased property. The appraisal shall be final and binding on the parties.

(m) *Liability at end of lease term based on residual value.* If the lessee is liable at the end of the lease term for the difference between the residual value of the leased property and its realized value:

(1) *Rent and other charges.* The rent and other charges, paid by the lessee and required by the lessor as an incident to the lease transaction, with a description such as "the total amount of rent and other charges imposed in connection with your lease [state the amount]."

(2) *Excess liability.* A statement about a rebuttable presumption that, at the end of the lease term, the residual value of the leased property is unreasonable and not in good faith to the extent that the residual value exceeds the realized value by more than three times the base monthly payment (or more than three times the average payment allocable to a monthly period, if the lease calls for periodic payments other than monthly); and that the lessor cannot collect the excess amount unless the lessor brings a successful court action and pays the lessee's reasonable attorney's fees, or unless the excess of the residual value over the realized value is due to unreasonable or excessive wear or use of the leased property (in which case the rebuttable presumption does not apply).

(3) *Mutually agreeable final adjustment.* A statement that the lessee and lessor are permitted, after termination of the lease, to make any mutually agreeable final adjustment regarding excess liability.

(n) *Fees and taxes.* The total dollar amount for all official and license fees, registration, title, or taxes required to be paid in connection with the lease.

(o) *Insurance.* A brief identification of insurance in connection with the lease including:

(1) *Through the lessor.* If the insurance is provided by or paid through the lessor, the types and amounts of coverage and the cost to the lessee; or

(2) *Through a third party.* If the lessee must obtain the insurance, the types and amounts of coverage required of the lessee.

(p) *Warranties or guarantees.* A statement identifying all express warranties and guarantees from the manufacturer or lessor with respect to the leased property that apply to the lessee.

(q) *Penalties and other charges for delinquency.* The amount or the method of determining the amount of any penalty or other charge for delinquency, default, or late payments, which must be reasonable.

(r) *Security interest.* A description of any security interest, other than a security deposit disclosed under paragraph (b) of this section, held or to be retained by the lessor; and a clear identification of the property to which the security interest relates.

(s) *Limitations on rate information.* If a lessor provides a percentage rate in an advertisement or in documents evidencing the lease transaction, a notice stating that "this percentage may not measure the overall cost of financing this lease" shall accompany the rate disclosure. The lessor shall not use the term "annual percentage rate," "annual lease rate," or any equivalent term.

(t) *Non–motor vehicle open-end leases.* Non–motor vehicle open-end leases remain subject to section 182(10) of the act regarding end-of-term liability.

SECTION 213.5—Renegotiations, Extensions, and Assumptions

(a) *Renegotiation.* A renegotiation occurs when a consumer lease subject to this part is satisfied and replaced by a new lease undertaken by the same consumer. A renegotiation requires new disclosures, except as provided in paragraph (d) of this section.

(b) *Extension.* An extension is a continuation, agreed to by the lessor and the lessee, of an existing consumer lease beyond the originally scheduled end of the lease term, except when the continuation is the result of a renegotiation. An extension that exceeds six months requires new disclosures, except as provided in paragraph (d) of this section.

(c) *Assumption.* New disclosures are not required when a consumer lease is assumed by another person, whether or not the lessor charges an assumption fee.

(d) *Exceptions.* New disclosures are not required for the following, even if they meet the definition of a renegotiation or an extension:

(1) a reduction in the rent charge;

(2) the deferment of one or more payments, whether or not a fee is charged;

(3) the extension of a lease for not more than six months on a month-to-month basis or otherwise;

(4) a substitution of leased property with property that has a substantially equivalent or greater economic value, provided no other lease terms are changed;

(5) the addition, deletion, or substitution of leased property in a multiple-item lease, provided the average periodic payment does not change by more than 25 percent; or

(6) an agreement resulting from a court proceeding.

SECTION 213.6

[Reserved]

SECTION 213.7—Advertising

(a) *General rule.* An advertisement for a consumer lease may state that a specific lease of property at specific amounts or terms is available only if the lessor usually and customarily leases or will lease the property at those amounts or terms.

(b) *Clear-and-conspicuous standard.* Disclosures required by this section shall be made clearly and conspicuously.

(1) *Amount due at lease signing.* Except for the statement of a periodic payment, any affirmative or negative reference to a charge that is a part of the disclosure required under paragraph (d)(2)(ii) of this section shall not be more prominent than that disclosure.

(2) *Advertisement of a lease rate.* If a lessor provides a percentage rate in an advertisement, the rate shall not be more prominent than any of the disclosures in section 213.4, with the exception of the notice in section 213.4(s) required to accompany the rate; and lessor shall not use the term "annual percentage rate," "annual lease rate," or equivalent term.

(c) *Catalogs and multipage advertisements.* A catalog or other multipage advertisement that provides a table or schedule of the required disclosures shall be considered a single advertisement if, for lease terms that appear without all the required disclosures, the advertisement refers to the page or pages on which the table or schedule appears.

(d) *Advertisement of terms that require additional disclosure.*

(1) *Triggering terms.* An advertisement that states any of the following items shall contain the disclosures required by paragraph (d)(2) of this section, except as provided in paragraphs (e) and (f) of this section:

(i) the amount of any payment; or

(ii) a statement of any capitalized cost reduction or other payment required prior to or at consummation or by delivery, if delivery occurs after confirmation.

(2) *Additional terms.* An advertisement stating any item listed in paragraph (d)(1) of this section shall also state the following items:

(i) that the transaction advertised is a lease;

(ii) the total amount due prior to or at consummation or by delivery, if delivery occurs after consummation;

(iii) the number, amounts, and due dates or periods of scheduled payments under the lease;

(iv) a statement of whether or not a security deposit is required; and

(v) a statement that an extra charge may be imposed at the end of the lease term where the lessee's liability (if any) is based on the difference between the residual value of the leased property and its realized value at the end of the lease term.

(e) *Alternative disclosures—merchandise tags.* A merchandise tag stating any item listed in paragraph (d)(1) of this section may comply with paragraph (d)(2) of this section by referring to a sign or display prominently posted in the lessor's place of business that contains a table or schedule of the required disclosures.

(f) *Alternative disclosures—television or radio advertisements.*

(1) *Toll-free number or print advertisement.* An advertisement made through television or radio stating any item listed in paragraph (d)(1) of this section complies with paragraph (d)(2) of this section if the advertisement states the items listed in paragraphs (d)(2)(i) through (iii) of this section, and—

(i) lists a toll-free telephone number along with a reference that such number may be used by consumers to obtain the information required by paragraph (d)(2) of this section; or

(ii) directs the consumer to a written advertisement in a publication of general circulation in the community served by the media station, including the name and the date of the publication, with a statement that information required by paragraph (d)(2) of this section is included in the advertisement. The written advertisement shall be published beginning at least three days before and ending at least ten days after the broadcast.

(2) *Establishment of toll-free number.*

(i) The toll-free telephone number shall be available for no fewer than ten days, beginning on the date of the broadcast.

(ii) The lessor shall provide the information required by paragraph (d)(2) of this section orally, or in writing upon request.

SECTION 213.8—Record Retention

A lessor shall retain evidence of compliance with the requirements imposed by this part, other than the advertising requirements under section 213.7, for a period of not less than two years after the date the disclosures are required to be made or an action is required to be taken.

SECTION 213.9—Relation to State Laws

(a) *Inconsistent state law.* A state law that is inconsistent with the requirements of the act and this part is preempted to the extent of the inconsistency. If a lessor cannot comply with a state law without violating a provision of this part, the state law is inconsistent within the meaning of section 186(a) of the act and is preempted, unless the state law gives greater protection and benefit to the consumer. A state, through an official having primary enforcement or interpretative responsibilities for the state consumer leasing law, may apply to the Board for a preemption determination.

(b) *Exemptions.*

(1) *Application.* A state may apply to the Board for an exemption from the requirements of the act and this part for any class of lease transactions within the state. The Board will grant such an exemption if the Board determines that—

(i) the class of leasing transactions is subject to state-law requirements substantially similar to the act and this part or that lessees are afforded greater protection under state law; and

(ii) there is adequate provision for state enforcement.

(2) *Enforcement and liability.* After an exemption has been granted, the requirements

of the applicable state law (except for additional requirements not imposed by federal law) will constitute the requirements of the act and this part. No exemption will extend to the civil liability provisions of sections 130, 131, and 185 of the act.

APPENDIX A—Model Forms

A-1—Model Open-End or Finance Vehicle Lease Disclosures

Appendix A-1 Model Open-End or Finance Vehicle Lease Disclosures

Federal Consumer Leasing Act Disclosures

Date ________________

Lessor(s) ______________________________ Lessee(s) ______________________________

Amount Due at Lease Signing or Delivery	Monthly Payments	Other Charges (not part of your monthly payment)	Total of Payments (The amount you will have paid by the end of the lease)
(Itemized below)* $ __________	Your first monthly payment of $ ________ is due on ____________, followed by _____ payments of $ ________ due on the ________ of each month. The total of your monthly payments is $ ________.	Disposition fee (if you do not purchase the vehicle) $ ________ ________________ ________ Total $ ________	$ __________ You will owe an additional amount if the actual value of the vehicle is less than the residual value.

*** Itemization of Amount Due at Lease Signing or Delivery**

Amount Due At Lease Signing or Delivery:		**How the Amount Due at Lease Signing or Delivery will be paid:**	
Capitalized cost reduction	$ ________	Net trade-in allowance	$ ________
First monthly payment	________	Rebates and noncash credits	________
Refundable security deposit	________	Amount to be paid in cash	________
Title fees	________	________________	________
Registration fees	________		
________________	________		
Total	$ ________	Total	$ ________

Your monthly payment is determined as shown below:

Gross capitalized cost. The agreed upon value of the vehicle ($____________) and any items you pay over the lease term (such as service contracts, insurance, and any outstanding prior credit or lease balance) .... $ ________

If you want an itemization of this amount, please check this box. ☐

Capitalized cost reduction. The amount of any net trade-in allowance, rebate, noncash credit, or cash you pay that reduces the gross capitalized cost .... – ________

Adjusted capitalized cost. The amount used in calculating your base monthly payment .... = ________

Residual value. The value of the vehicle at the end of the lease used in calculating your base monthly payment .... – ________

Depreciation and any amortized amounts. The amount charged for the vehicle's decline in value through normal use and for other items paid over the lease term .... = ________

Rent charge. The amount charged in addition to the depreciation and any amortized amounts .... + ________

Total of base monthly payments. The depreciation and any amortized amounts plus the rent charge .... = ________

Lease term. The number of months in your lease .... ÷ ________

Base monthly payment .... = ________

Monthly sales/use tax .... + ________

________________ .... + ________

Total monthly payment .... =$ ________

Rent and other charges. The total amount of rent and other charges imposed in connection with your lease $ __________.

Early Termination. You may have to pay a substantial charge if you end this lease early. The charge may be up to several thousand dollars. The actual charge will depend on when the lease is terminated. The earlier you end the lease, the greater this charge is likely to be.

Excessive Wear and Use. You may be charged for excessive wear based on our standards for normal use [and for mileage in excess of ________ miles per year at the rate of ______ per mile].

Purchase Option at End of Lease Term. [You have an option to purchase the vehicle at the end of the lease term for $ ________ [and a purchase option fee of $ ____________].] [You do not have an option to purchase the vehicle at the end of the lease term.]

Other Important Terms. See your lease documents for additional information on early termination, purchase options and maintenance responsibilities, warranties, late and default charges, insurance, and any security interest, if applicable.

Appendix A-1 Model Open-End or Finance Vehicle Lease Disclosures

Page 2 of 2

[The following provisions are the nonsegregated disclosures required under Regulation M.]

Description of Leased Property				
Year	Make	Model	Body Style	Vehicle ID #

Official Fees and Taxes. The total amount you will pay for official and license fees, registration, title, and taxes over the term of your lease, whether included with your monthly payments or assessed otherwise: $________________.

Insurance. The following types and amounts of insurance will be acquired in connection with this lease:

____.

________ We (lessor) will provide the insurance coverage quoted above for a total premium cost of $________________.

________ You (lessee) agree to provide insurance coverage in the amount and types indicated above.

End of Term Liability. (a) The residual value ($______________) of the vehicle is based on a reasonable, good faith estimate of the value of the vehicle at the end of the lease term. If the actual value of the vehicle at that time is greater than the residual value, you will have no further liability under this lease, except for other charges already incurred [and are entitled to a credit or refund of any surplus.] If the actual value of the vehicle is less than the residual value, you will be liable for any difference up to $______________ (3 times the monthly payment). For any difference in excess of that amount, you will be liable only if:
1. Excessive use or damage [as described in paragraph ____] [representing more than normal wear and use] resulted in an unusually low value at the end of the term.
2. The matter is not otherwise resolved and we win a lawsuit against you seeking a higher payment.
3. You voluntarily agree with us after the end of the lease term to make a higher payment.
Should we bring a lawsuit against you, we must prove that our original estimate of the value of the leased property at the end of the lease term was reasonable and was made in good faith. For example, we might prove that the actual was less than the original estimated value, although the original estimate was reasonable, because of an unanticipated decline in value for that type of vehicle. We must also pay your attorney's fees.
(b) If you disagree with the value we assign to the vehicle, you may obtain, at your own expense, from an independent third party agreeable to both of us, a professional appraisal of the __________ value of the leased vehicle which could be realized at sale. The appraised value shall then be used as the actual value.

Standards for Wear and Use. The following standards are applicable for determining unreasonable or excess wear and use of the leased vehicle:

____

Maintenance.
[You are responsible for the following maintenance and servicing of the leased vehicle:

____].

[We are responsible for the following maintenance and servicing of the leased vehicle:

____].

Warranties. The leased vehicle is subject to the following express warranties:

____.

Early Termination and Default. (a) You may terminate this lease before the end of the lease term under the following conditions:

____.

The charge for such early termination is:

____.

(b) We may terminate this lease before the end of the lease term under the following conditions:

____.

Upon such termination we shall be entitled to the following charge(s) for:

____.

(c) To the extent these charges take into account the value of the vehicle at termination, if you disagree with the value we assign to the vehicle, you may obtain, at your own expense, from an independent third party agreeable to both of us, a professional appraisal of the ________________ value of the leased vehicle which could be realized at sale. The appraised value shall then be used as the actual value.

Security Interest. We reserve a security interest of the following type in the property listed below to secure performance of your obligation under this lease:

____.

Late Payments. The charge for late payments is: ____.

Option to Purchase Leased Property Prior to the End of the Lease. [You have an option to purchase the leased vehicle prior to the end of the term. The price will be [$____________________ /[the method of determining the price].] [You do not have an option to purchase the leased vehicle.]

A-2—Model Closed-End or Net Vehicle Lease Disclosures

Appendix A-2 Model Closed-End or Net Vehicle Lease Disclosures

Federal Consumer Leasing Act Disclosures

Date ____________________

Lessor(s) ____________________ Lessee(s) ____________________

Amount Due at Lease Signing or Delivery	Monthly Payments	Other Charges (not part of your monthly payment)	Total of Payments (The amount you will have paid by the end of the lease)
(Itemized below)* $ __________	Your first monthly payment of $ __________ is due on ______________, followed by _____ payments of $ ________ due on the ________ of each month. The total of your monthly payments is $ __________.	Disposition fee (if you do not purchase the vehicle) $ ________ ____________ ________ Total $ ________	$ __________

*** Itemization of Amount Due at Lease Signing or Delivery**

Amount Due At Lease Signing or Delivery:		How the Amount Due at Lease Signing or Delivery will be paid:	
Capitalized cost reduction	$ __________	Net trade-in allowance	$ __________
First monthly payment	__________	Rebates and noncash credits	__________
Refundable security deposit	__________	Amount to be paid in cash	__________
Title fees	__________	____________	__________
Registration fees	__________		
____________	__________		
Total	$ __________	Total	$ __________

Your monthly payment is determined as shown below:

Gross capitalized cost. The agreed upon value of the vehicle ($______________) and any items you pay over the lease term (such as service contracts, insurance, and any outstanding prior credit or lease balance) .... $ __________

If you want an itemization of this amount, please check this box. ☐

Capitalized cost reduction. The amount of any net trade-in allowance, rebate, noncash credit, or cash you pay that reduces the gross capitalized cost	–	__________
Adjusted capitalized cost. The amount used in calculating your base monthly payment	=	__________
Residual value. The value of the vehicle at the end of the lease used in calculating your base monthly payment	–	__________
Depreciation and any amortized amounts. The amount charged for the vehicle's decline in value through normal use and for other items paid over the lease term	=	__________
Rent charge. The amount charged in addition to the depreciation and any amortized amounts	+	__________
Total of base monthly payments. The depreciation and any amortized amounts plus the rent charge	=	__________
Lease term. The number of months in your lease	÷	__________
Base monthly payment	=	__________
Monthly sales/use tax	+	__________
____________	+	__________
Total monthly payment	=$	__________

Early Termination. You may have to pay a substantial charge if you end this lease early. The charge may be up to several thousand dollars. The actual charge will depend on when the lease is terminated. The earlier you end the lease, the greater this charge is likely to be.

Excessive Wear and Use. You may be charged for excessive wear based on our standards for normal use [and for mileage in excess of ________ miles per year at the rate of _______ per mile].

Purchase Option at End of Lease Term. [You have an option to purchase the vehicle at the end of the lease term for $ __________ [and a purchase option fee of $ ______________].] [You do not have an option to purchase the vehicle at the end of the lease term.]

Other Important Terms. See your lease documents for additional information on early termination, purchase options and maintenance responsibilities, warranties, late and default charges, insurance, and any security interest, if applicable.

Appendix A-2 Model Closed-End or Net Vehicle Lease Disclosures

Page 2 of 2

[The following provisions are the nonsegregated disclosures required under Regulation M.]

Description of Leased Property				
Year	Make	Model	Body Style	Vehicle ID #

Official Fees and Taxes. The total amount you will pay for official and license fees, registration, title, and taxes over the term of your lease, whether included with your monthly payments or assessed otherwise: $________________.

Insurance. The following types and amounts of insurance will be acquired in connection with this lease:
____.

________ We (lessor) will provide the insurance coverage quoted above for a total premium cost of $ ________________.

________ You (lessee) agree to provide insurance coverage in the amount and types indicated above.

Standards for Wear and Use. The following standards are applicable for determining unreasonable or excess wear and use of the leased vehicle:
____

Maintenance.
[You are responsible for the following maintenance and servicing of the leased vehicle:
____].

[We are responsible for the following maintenance and servicing of the leased vehicle:
____].

Warranties. The leased vehicle is subject to the following express warranties:
____.

Early Termination and Default. (a) You may terminate this lease before the end of the lease term under the following conditions:
____.

The charge for such early termination is:
____.

(b) We may terminate this lease before the end of the lease term under the following conditions:
____.

Upon such termination we shall be entitled to the following charge(s) for:
____.

(c) To the extent these charges take into account the value of the vehicle at termination, if you disagree with the value we assign to the vehicle, you may obtain, at your own expense, from an independent third party agreeable to both of us, a professional appraisal of the __________________ value of the leased vehicle which could be realized at sale. The appraisal value shall then be used as the actual value.

Security Interest. We reserve a security interest of the following type in the property listed below to secure performance of your obligation under this lease:
____.

Late Payments. The charge for late payments is: ______________________________.

Option to Purchase Leased Property Prior to the End of the Lease. [You have an option to purchase the leased vehicle prior to the end of the term. The price will be [$____________________ /[the method of determining the price].] [You do not have an option to purchase the leased vehicle.]

A-3—Model Furniture Lease Disclosures

Appendix A-3 Model Furniture Lease Disclosures

Federal Consumer Leasing Act Disclosures

Date ____________________

Lessor(s) ______________________________ **Lessee(s)** ______________________________

Description of Leased Property				
Item	Color	Stock #	Mfg.	Quantity

Amount Due at Lease Signing	**Monthly Payments**	**Other Charges** (not part of your monthly payment)	**Total of Payments** (The amount you will have paid by the end of the lease)
First monthly payment $ ______ Refundable security deposit $ ______ Delivery/Installation fee $ ______ ____________ $ ______ Total $ ______	Your first monthly payment of $ __________ is due on ______________, followed by _____ payments of $ _________ due on the ________ of each month. The total of your monthly payments is $ __________.	Pick-up fee $ ______ ________ $ ______ Total $ ______	$ ____________

Purchase Option at End of Lease Term. [You have an option to purchase the leased property at the end of the lease term for $ ________ [and a purchase option fee of $ ____________].] [You do not have an option to purchase the leased property at the end of the lease term.]

Other Important Terms. See your lease documents for additional information on early termination, purchase options and maintenance responsibilities, warranties, late and default charges, insurance, and any security interest, if applicable.

[The following provisions are the nonsegregated disclosures required under Regulation M.]

Official Fees and Taxes. The total amount you will pay for official fees, and taxes over the term of your lease, whether included with your monthly payments or assessed otherwise: $ ______________ .

Insurance. The following types and amounts of insurance will be acquired in connection with this lease: ____.

_____ We (lessor) will provide the insurance coverage quoted above for a total premium cost of $ ______________ .

_____ You (lessee) agree to provide insurance coverage in the amount and types indicated above.

Standards for Wear and Use. The following standards are applicable for determining unreasonable or excess wear and use of the leased property:
____

Maintenance.

[You are responsible for the following maintenance and servicing of the leased property:
____.]

[We are responsible for the following maintenance and servicing of the leased property:
____.]

Warranties. The leased property is subject to the following express warranties:
____.

Early Termination and Default. (a) You may terminate this lease before the end of the lease term under the following conditions:
____.

The charge for such early termination is: ____.

(b) We may terminate this lease before the end of the lease term under the following conditions: ____________________.

Upon such termination we shall be entitled to the following charge(s) for: ____________________.

Appendix A-3 Model Furniture Lease Disclosures

Early Termination and Default. (continued)

(c) To the extent these charges take into account the value of the leased property at termination, if you disagree with the value we assign to the property, you may obtain, at your own expense, from an independent third party agreeable to both of us, a professional appraisal of the ____________ value of the property which could be realized at sale. The appraised value shall then be used as the actual value.

Security Interest. We reserve a security interest of the following type in the property listed below to secure performance of your obligations under this lease: ____________.

Late Payments. The charge for late payments is: ____________.

Purchase Option Prior to the End of the Lease Term.

[You have an option to purchase the leased property prior to the end of the term. The price will be [$ ________]/the method of determining the price].]

[You do not have an option to purchase the leased property.]

APPENDIX B—Federal Enforcement Agencies

The following list indicates which federal agency enforces Regulation M (12 CFR 213) for particular classes of business. Any questions concerning compliance by a particular business should be directed to the appropriate enforcement agency. Terms that are not defined in the Federal Deposit Insurance Act (12 USC 1813(s)) shall have the meaning given to them in the International Banking Act of 1978 (12 USC 3101).

1. *National banks and federal branches and federal agencies of foreign banks*
District office of the Office of the Comptroller of the Currency for the district in which the institution is located.

2. *State member banks, branches and agencies of foreign banks (other than federal branches, federal agencies, and insured state branches of foreign banks), commercial lending companies owned or controlled by foreign banks, and organizations operating under section 25 or 25A of the Federal Reserve Act*
Federal Reserve Bank serving the District in which the institution is located.

3. *Nonmember insured banks and insured state branches of foreign banks*
Federal Deposit Insurance Corporation Regional Director for the region in which the institution is located.

4. *Savings institutions insured under the Savings Association Insurance Fund of the FDIC and federally chartered savings banks insured under the Bank Insurance Fund of the FDIC (but not including state-chartered savings banks insured under the Bank Insurance Fund)*
Office of Thrift Supervision regional director for the region in which the institution is located.

5. *Federal credit unions*
Regional office of the National Credit Union Administration serving the area in which the federal credit union is located.

6. *Air carriers*
Assistant General Counsel for
Aviation Enforcement and Proceedings
Department of Transportation
400 Seventh Street, S.W.
Washington, D.C. 20590

7. *Those subject to Packers and Stockyards Act*
Nearest Packers and Stockyards Administration area supervisor.

8. *Federal Land Banks, Federal Land Bank Associations, Federal Intermediate Credit Banks, and Production Credit Associations*
Farm Credit Administration
490 L'Enfant Plaza, S.W.
Washington, D.C. 20578

9. *All other lessors (lessors operating on a local or regional basis should use the address of the FTC regional office in which they operate)*
Division of Credit Practices
Bureau of Consumer Protection
Federal Trade Commission
Washington, D.C. 20580

APPENDIX C—Issuance of Staff Interpretations

Officials in the Board's Division of Consumer and Community Affairs are authorized to issue official staff interpretations of this Regulation M (12 CFR 213). These interpretations provide the formal protection afforded under section 130(f) of the act. Except in unusual circumstances, interpretations will not be issued separately but will be incorporated in an official commentary to Regulation M (supplement I of this part), which will be amended periodically. No staff interpretations will be issued approving lessor's forms, statements, or calculation tools or methods.

CHAPTER 5—CONSUMER LEASES

SECTION 181—Definitions

For purposes of this chapter—

(1) The term *"consumer lease"* means a contract in the form of a lease or bailment for the use of personal property by a natural person for a period of time exceeding four months, and for a total contractual obligation not exceeding $25,000, primarily for personal, family, or household purposes, whether or not the lessee has the option to purchase or otherwise become the owner of the property at the expiration of the lease, except that such term shall not include any credit sale as defined in section 103(g). Such term does not include a lease for agricultural, business, or commercial purposes, or to a government or governmental agency or instrumentality, or to an organization.

(2) The term *"lessee"* means a natural person who leases or is offered a consumer lease.

(3) The term *"lessor"* means a person who is regularly engaged in leasing, offering to lease, or arranging to lease under a consumer lease.

(4) The term *"personal property"* means any property which is not real property under the laws of the State where situated at the time offered or otherwise made available for lease.

(5) The terms *"security"* and *"security interest"* mean any interest in property which secures payment or performance of an obligation.

[15 USC 1667. As added by act of March 23, 1976 (90 Stat. 257).]

SECTION 182—Consumer Lease Disclosures

Each lessor shall give a lessee prior to the consummation of the lease a dated written statement on which the lessor and lessee are identified setting out accurately and in a clear and conspicuous manner the following information with respect to that lease, as applicable:

(1) A brief description or identification of the leased property;

(2) The amount of any payment by the lessee required at the inception of the lease;

(3) The amount paid or payable by the lessee for official fees, registration, certificate of title, or license fees or taxes;

(4) The amount of other charges payable by the lessee not included in the periodic payments, a description of the charges and that the lessee shall be liable for the differential, if any, between the anticipated fair market value of the leased property and its appraised actual value at the termination of the lease, if the lessee has such liability;

(5) A statement of the amount or method of determining the amount of any liabilities the lease imposes upon the lessee at the end of the term and whether or not the lessee has the option to purchase the leased property and at what price and time;

(6) A statement identifying all express warranties and guarantees made by the manufacturer or lessor with respect to the leased property, and identifying the party responsible for maintaining or servicing the leased property together with a description of the responsibility;

(7) A brief description of insurance provided or paid for by the lessor or required of the lessee, including the types and amounts of the coverages and costs;

(8) A description of any security interest held or to be retained by the lessor in connection with the lease and a clear identification of the property to which the security interest relates;

(9) The number, amount, and due dates or periods of payments under the lease and the total amount of such periodic payments;

(10) Where the lease provides that the lessee shall be liable for the anticipated fair market value of the property on expiration of the lease, the fair market value of the property at the inception of the lease, the

aggregate cost of the lease on expiration, and the differential between them; and

(11) A statement of the conditions under which the lessee or lessor may terminate the lease prior to the end of the term and the amount or method of determining any penalty or other charge for delinquency, default, late payments, or early termination.

The disclosures required under this section may be made in the lease contract to be signed by the lessee. The Board may provide by regulation that any portion of the information required to be disclosed under this section may be given in the form of estimates where the lessor is not in a position to know exact information.

[15 USC 1667a. As added by act of March 23, 1976 (90 Stat. 258).]

SECTION 183—Lessee's Liability on Expiration or Termination of Lease

(a) Where the lessee's liability on expiration of a consumer lease is based on the estimated residual value of the property such estimated residual value shall be a reasonable approximation of the anticipated actual fair market value of the property on lease expiration. There shall be a rebuttable presumption that the estimated residual value is unreasonable to the extent that the estimated residual value exceeds the actual residual value by more than three times the average payment allocable to a monthly period under the lease. In addition, where the lessee has such liability on expiration of a consumer lease there shall be a rebuttable presumption that the lessor's estimated residual value is not in good faith to the extent that the estimated residual value exceeds the actual residual value by more than three times the average payment allocable to a monthly period under the lease and such lessor shall not collect from the lessee the amount of such excess liability on expiration of a consumer lease unless the lessor brings a successful action with respect to such excess liability. In all actions, the lessor shall pay the lessee's reasonable attorney's fees. The presumptions stated in this section shall not apply to the extent the excess of estimated over actual residual value is due to physical damage to the property beyond reasonable wear and use, or to excessive use, and the lease may set standards for such wear and use if such standards are not unreasonable. Nothing in this subsection shall preclude the right of a willing lessee to make any mutually agreeable final adjustment with respect to such excess residual liability, provided such an agreement is reached after termination of the lease.

(b) Penalties or other charges for delinquency, default, or early termination may be specified in the lease but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the delinquency, default, or early termination, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy.

(c) If a lease has a residual value provision at the termination of the lease, the lessee may obtain at his expense, a professional appraisal of the leased property by an independent third party agreed to by both parties. Such appraisal shall be final and binding on the parties.

[15 USC 1667b. As added by act of March 23, 1976 (90 Stat. 259).]

SECTION 184—Consumer Lease Advertising

(a) *In general.* If an advertisement for a consumer lease includes a statement of the amount of any payment or a statement that any or no initial payment is required, the advertisement shall clearly and conspicuously state, as applicable—

(1) the transaction advertised is a lease;

(2) the total amount of any initial payments required on or before consummation of the lease or delivery of the property, whichever is later;

(3) that a security deposit is required;

(4) the number, amount, and timing of scheduled payments; and

(5) with respect to a lease in which the liability of the consumer at the end of the lease term is based on the anticipated residual value of the property, that an extra charge may be imposed at the end of the lease term.

(b) *Advertising medium not liable.* No owner or employee of any entity that serves as a medium in which an advertisement appears or through which an advertisement is disseminated, shall be liable under this section.

(c) *Radio advertisements.*

(1) An advertisement by radio broadcast to aid, promote, or assist, directly or indirectly, any consumer lease shall be deemed to be in compliance with the requirements of subsection (a) if such advertisement clearly and conspicuously—

(A) states the information required by paragraphs (1) and (2) of subsection (a);

(B) states the number, amounts, due dates or periods of scheduled payments, and the total of such payments under the lease;

(C) includes—

(i) a referral to—

(I) a toll-free telephone number established in accordance with paragraph (2) that may be used by consumers to obtain the information required under subsection (a); or

(II) a written advertisement that—

(aa) appears in a publication in general circulation in the community served by the radio station on which such advertisement is broadcast during the period beginning 3 days before any such broadcast and ending 10 days after such broadcast; and

(bb) includes the information required to be disclosed under subsection (a); and

(ii) the name and dates of any publication referred to in clause (i)(II); and

(D) includes any other information which the Board determines necessary to carry out this chapter.

(2) (A) In the case of a radio broadcast advertisement described in paragraph (1) that includes a referral to a toll-free telephone number, the lessor who offers the consumer lease shall—

(i) establish such a toll-free telephone number not later than the date on which the advertisement including the referral is broadcast;

(ii) maintain such telephone number for a period of not less than 10 days, beginning on the date of any such broadcast; and

(iii) provide the information required under subsection (a) with respect to the lease to any person who calls such number.

(B) The information required to be provided under subparagraph (A)(iii) shall be provided verbally or, if requested by the consumer, in written form.

(3) Nothing in this subsection shall affect the requirements of Federal law as such requirements apply to advertisement by any medium other than radio broadcast.

[15 USC 1667c. As added by act of March 23, 1976 (90 Stat. 259) and amended by acts of Sept. 23, 1994 (108 Stat. 2234) and Sept. 30, 1996 (110 Stat. 3009-473).]

SECTION 185—Civil Liability

(a) Any lessor who fails to comply with any requirement imposed under section 182 or 183 of this chapter with respect to any person is liable to such person as provided in section 130.

(b) Any lessor who fails to comply with any requirement imposed under section 184 of this chapter with respect to any person who suffers actual damage from the violation is liable to such person as provided in section 130. For the purposes of this section, the term "creditor" as used in sections 130 and 131 shall include a lessor as defined in this chapter.

(c) Notwithstanding section 130(e), any action under this section may be brought in any United States district court or in any other court of competent jurisdiction. Such actions alleging a failure to disclose or otherwise comply with the requirements of this chapter shall be brought within one year of the termination of the lease agreement.

[15 USC 1667d. As added by act of March 23, 1976 (90 Stat. 260).]

SECTION 186—Relation to State Laws

(a) This chapter does not annul, alter, or affect, or exempt any person subject to the provisions of this chapter from complying with, the laws of any State with respect to consumer leases, except to the extent that those laws are inconsistent with any provision of this chapter, and then only to the extent of the inconsistency. The Board is authorized to determine whether such inconsistencies exist. The Board may not determine that any State law is inconsistent with any provision of this chapter if the Board determines that such law gives greater protection and benefit to the consumer.

(b) The Board shall by regulation exempt from the requirements of this chapter any class of lease transactions within any State if it determines that under the law of that State that class of transactions is subject to requirements substantially similar to those imposed under this chapter or that such law gives greater protection and benefit to the consumer, and that there is adequate provision for enforcement.

[15 USC 1667e. As added by act of March 23, 1976 (90 Stat. 260).]

SECTION 187—Regulations

(a) *Regulations authorized.*

(1) The Board shall prescribe regulations to update and clarify the requirements and definitions applicable to lease disclosures and contracts, and any other issues specifically related to consumer leasing, to the extent that the Board determines such action to be necessary—

(A) to carry out this chapter;

(B) to prevent any circumvention of this chapter; or

(C) to facilitate compliance with the requirements of the chapter.

(2) Any regulations prescribed under paragraph (1) may contain classifications and differentiations, and may provide for adjustments and exceptions for any class of transactions, as the Board considers appropriate.

(b) *Model disclosure.*

(1) The Board shall establish and publish model disclosure forms to facilitate compliance with the disclosure requirements of this chapter and to aid the consumer in understanding the transaction to which the subject disclosure form relates.

(2) In establishing model forms under this subsection, the Board shall consider the use by lessors of data processing or similar automated equipment.

(3) A lessor may utilize a model disclosure form established by the Board under this subsection for purposes of compliance with this chapter, at the discretion of the lessor.

(4) Any lessor who properly uses the material aspects of any model disclosure form established by the Board under this subsection shall be deemed to be in compliance with the disclosure requirements to which the form relates.

[15 USC 1667f. As added by act of Sept. 30, 1996 (110 Stat. 3009-472).]

Board of Governors of the Federal Reserve System

Capital Adequacy Guidelines

12 CFR 208, Appendix A; as amended effective January 1, 1997
12 CFR 208, Appendix B; as amended effective August 1, 1995
12 CFR 208, Appendix E; effective January 1, 1997
12 CFR 225, Appendix A; as amended effective October 1, 1995
12 CFR 225, Appendix B; as amended effective September 1, 1995
12 CFR 225, Appendix D; as amended effective August 1, 1995
12 CFR 225, Appendix E; effective January 1, 1997

Any inquiry relating to these guidelines should be addressed to the Federal Reserve Bank of the Federal Reserve District in which the inquiry arises.

July 1997

Contents

Capital Adequacy Guidelines for State Member Banks: Risk-Based Measure

12 CFR 208, appendix A; as amended effective January 1, 1997

I. Overview

The Board of Governors of the Federal Reserve System has adopted a risk-based capital measure to assist in the assessment of the capital adequacy of state member banks.[1] The principal objectives of this measure are to (i) make regulatory capital requirements more sensitive to differences in risk profiles among banks; (ii) factor off-balance-sheet exposures into the assessment of capital adequacy; (iii) minimize disincentives to holding liquid, low-risk assets; and (iv) achieve greater consistency in the evaluation of the capital adequacy of major banks throughout the world.[2]

In addition, when certain banks that engage in trading activities calculate their risk-based capital ratio under this appendix A, they must also refer to appendix E of this part. which incorporates capital charges for certain market risks into the risk-based capital ratio. When calculating their risk-based capital ratio under this appendix A, such banks are required to refer to appendix E of this part for supplemental rules to determine qualifying and excess capital, calculate risk-weighted assets, calculate market-risk-equivalent assets, and calculate risk-based capital ratios adjusted for market risk.

The risk-based capital guidelines include both a definition of capital and a framework for calculating weighted-risk assets by assigning assets and off-balance-sheet items to broad risk categories. A bank's risk-based capital ratio is calculated by dividing its qualifying capital (the numerator of the ratio) by its weighted-risk assets (the denominator).[3] The definition of "qualifying capital" is outlined below in section II, and the procedures for calculating weighted-risk assets are discussed in section III. Attachment I illustrates a sample calculation of weighted-risk assets and the risk-based capital ratio.

The risk-based capital guidelines also establish a schedule for achieving a minimum supervisory standard for the ratio of qualifying capital to weighted-risk assets and provide for transitional arrangements during a phase-in period to facilitate adoption and implementation of the measure at the end of 1992. These interim standards and transitional arrangements are set forth in section IV.

The risk-based guidelines apply to all state member banks on a consolidated basis. They are to be used in the examination and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. Thus, in considering an application filed by a state member bank, the Federal Reserve will take into account the bank's risk-based capital ratio, the reasonableness of its capital plans, and the degree of progress it has demonstrated toward meeting the interim and final risk-based capital standards.

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; certain risks arising

1 Supervisory ratios that relate capital to total assets for state member banks are outlined in appendix B of this part and in appendix B to part 225 of the Federal Reserve's Regulation Y, 12 CFR 225.

2 The risk-based capital measure is based upon a framework developed jointly by supervisory authorities from the countries represented on the Basle Committee on Banking Regulations and Supervisory Practices (Basle Supervisors' Committee) and endorsed by the Group of Ten Central Bank Governors. The framework is described in a paper prepared by the BSC entitled "International Convergence of Capital Measurement," July 1988.

3 Banks will initially be expected to utilize period-end amounts in calculating their risk-based capital ratios. When necessary and appropriate, ratios based on average balances may also be calculated on a case-by-case basis. Moreover, to the extent banks have data on average balances that can be used to calculate risk-based ratios, the Federal Reserve will take such data into account.

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 as well as a bank's exposure to declines in the economic value of its capital due to changes in interest rates. For this reason, the final supervisory judgment 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.

The risk-based capital guidelines establish *minimum* ratios of capital to weighted-risk assets. In light of the considerations just discussed, banks generally are expected to operate well above the minimum risk-based ratios. In particular, banks contemplating significant expansion proposals are expected to maintain strong capital levels substantially above the minimum ratios and should not allow significant diminution of financial strength below these strong levels to fund their expansion plans. Institutions with high or inordinate levels of risk are also expected to operate well above minimum capital standards. In all cases, institutions should hold capital commensurate with the level and nature of the risks to which they are exposed. Banks that do not meet the minimum risk-based standard, or that are otherwise considered to be inadequately capitalized, are expected to develop and implement plans acceptable to the Federal Reserve for achieving adequate levels of capital within a reasonable period of time.

The Board will monitor the implementation and effect of these guidelines in relation to domestic and international developments in the banking industry. When necessary and appropriate, the Board will consider the need to modify the guidelines in light of any significant changes in the economy, financial markets, banking practices, or other relevant factors.

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

A bank's qualifying total capital consists of two types of capital components: "core capital elements" (comprising tier 1 capital) and "supplementary capital elements" (comprising tier 2 capital). These capital elements and the various limits, restrictions, and deductions to which they are subject, are discussed below and are set forth in attachment II.

To qualify as an element of tier 1 or tier 2 capital, a capital instrument may not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices.

Redemptions of permanent equity or other capital instruments before stated maturity could have a significant impact on a bank's overall capital structure. Consequently, a bank considering such a step should consult with the Federal Reserve before redeeming any equity or debt capital instrument (prior to maturity) if such redemption could have a material effect on the level or composition of the institution's capital base.[4]

A. The Components of Qualifying Capital

1. *Core capital elements (tier 1 capital).* The tier 1 component of a bank's qualifying capital must represent at least 50 percent of qualifying total capital and may consist of the following items that are defined as core capital elements:

i. common stockholders' equity
ii. qualifying noncumulative perpetual preferred stock (including related surplus)
iii. minority interest in the equity accounts of consolidated subsidiaries

Tier 1 capital is generally defined as the sum of core capital elements[5] less goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of this appendix.

[4] Consultation would not ordinarily be necessary if an instrument were redeemed with the proceeds of, or replaced by, a like amount of a similar or higher-quality capital instrument and the organization's capital position is considered fully adequate by the Federal Reserve.

[5] During the transition period and subject to certain limitations set forth in section IV below, tier 1 capital may also include items defined as supplementary capital elements.

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

b. *Perpetual preferred stock.* Perpetual preferred stock is defined as preferred stock that does not have a maturity date, that cannot be redeemed at the option of the holder of the instrument, and that has no other provisions that will require future redemption of the issue. Consistent with these provisions, any perpetual preferred stock with a feature permitting redemption at the option of the issuer may qualify as capital *only if* the redemption is subject to prior approval of the Federal Reserve. In general, preferred stock will qualify for inclusion in capital only if it can absorb losses while the issuer operates as a going concern (a fundamental characteristic of equity capital) *and* only if the issuer has the ability and legal right to defer or eliminate preferred dividends.

The only form of perpetual preferred stock that state member banks may consider as an element of tier 1 capital is noncumulative perpetual preferred. While the guidelines allow for the inclusion of noncumulative perpetual preferred stock in tier 1, it is desirable from a supervisory standpoint that voting common stockholders' equity remain the dominant form of tier 1 capital. Thus, state member banks should avoid overreliance on preferred stock or nonvoting equity elements within tier 1.

Perpetual preferred stock in which the dividend is reset periodically based, in whole or in part, upon the bank's current credit standing (that is, auction rate perpetual preferred stock, including so-called Dutch auction, money market, and remarketable preferred) will not qualify for inclusion in tier 1 capital.[6] [7] Such instruments, however, qualify for inclusion in tier 2 capital.

c. *Minority interest in equity accounts of consolidated subsidiaries.* This element is included in tier 1 because, as a general rule, it represents equity that is freely available to absorb losses in operating subsidiaries. While not subject to an explicit sublimit within tier 1, banks are expected to avoid using minority interest in the equity accounts of consolidated subsidiaries as an avenue for introducing into their capital structures elements that might not otherwise qualify as tier 1 capital or that would, in effect, result in an excessive reliance on preferred stock within tier 1.

2. *Supplementary capital elements (tier 2 capital).* The tier 2 component of a bank's qualifying total capital may consist of the following items that are defined as supplementary capital elements:

i. allowance for loan and lease losses (subject to limitations discussed below)
ii. perpetual preferred stock and related surplus (subject to conditions discussed below)
iii. hybrid capital instruments (as defined below) and mandatory convertible debt securities
iv. term subordinated debt and intermediate-term preferred stock, including related surplus (subject to limitations discussed below)

The maximum amount of tier 2 capital that may be included in a bank's qualifying total capital is limited to 100 percent of tier 1 capital (net of goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of this appendix).

The elements of supplementary capital are discussed in greater detail below.[8]

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6 Reserved.

7 Adjustable-rate noncumulative perpetual preferred stock (that is, perpetual preferred stock in which the dividend rate is not affected by the issuer's credit standing or financial condition but is adjusted periodically according to a formula based solely on general market interest rates) may be included in tier 1.

8 The Basle capital framework also provides for the inclusion of "undisclosed reserves" in tier 2. As defined in Continued

a. *Allowance for loan and lease losses.* Allowances for loan and lease losses are reserves that have been established through a charge against earnings to absorb future losses on loans or lease financing receivables. Allowances for loan and lease losses exclude "allocated transfer risk reserves,"[9] and reserves created against identified losses.

During the transition period, the risk-based capital guidelines provide for reducing the amount of this allowance that may be included in an institution's total capital. Initially, it is unlimited. However, by year-end 1990, the amount of the allowance for loan and lease losses that will qualify as capital will be limited to 1.5 percent of an institution's weighted risk assets. By the end of the transition period, the amount of the allowance qualifying for inclusion in tier 2 capital may not exceed 1.25 percent of weighted risk assets.[10]

b. *Perpetual preferred stock.* Perpetual preferred stock, as noted above, is defined as preferred stock that has no maturity date, that cannot be redeemed at the option of the holder, and that has no other provisions that will require future redemption of the issue. Such instruments are eligible for inclusion in tier 2 capital without limit.[11]

c. *Hybrid capital instruments and mandatory convertible debt securities.* Hybrid capital instruments include instruments that are essentially permanent in nature and that have certain characteristics of both equity and debt. Such instruments may be included in tier 2 without limit. The general criteria hybrid capital instruments must meet in order to qualify for inclusion in tier 2 capital are listed below:

1. The instrument must be unsecured; fully paid up; and subordinated to general creditors and must also be subordinated to claims of depositors.
2. The instrument must not be redeemable at the option of the holder prior to maturity, except with the prior approval of the Federal Reserve. (Consistent with the Board's criteria for perpetual debt and mandatory convertible securities, this requirement implies that holders of such instruments may not accelerate the payment of principal except in the event of bankruptcy, insolvency, or reorganization.)
3. The instrument must be available to participate in losses while the issuer is operating as a going concern. (Term subordinated debt would not meet this requirement.) To satisfy this requirement, the instrument must convert to common or perpetual preferred stock in the event that the accumulated losses exceed the sum of the retained earnings and capital surplus accounts of the issuer.
4. The instrument must provide the option for the issuer to defer interest payments if (a) the issuer does not report a profit in the preceding annual period (defined as combined profits for the most recent four quarters) *and* (b) the issuer eliminates cash dividends on common and preferred stock.

Mandatory convertible debt securities in the form of equity contract notes that meet

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Continued

the framework, undisclosed reserves represent accumulated after-tax retained earnings that are not disclosed on the balance sheet of a bank. Apart from the fact that these reserves are not disclosed publicly, they are essentially of the same quality and character as retained earnings, and, to be included in capital, such reserves must be accepted by the bank's home supervisor. Although such undisclosed reserves are common in some countries, under generally accepted accounting principles (GAAP) and long-standing supervisory practice, these types of reserves are not recognized for state member banks.

[9] Allocated transfer risk reserves are reserves that have been established in accordance with section 905(a) of the International Lending Supervision Act of 1983, 12 USC 3904(a), against certain assets whose value U.S. supervisory authorities have found to be significantly impaired by protracted transfer risk problems.

[10] The amount of the allowance for loan and lease losses that may be included in tier 2 capital is based on a percentage of gross weighted-risk assets. A bank may deduct reserves for loan and lease losses in excess of the amount permitted to be included in tier 2 capital, as well as allocated transfer risk reserves, from the sum of gross weighted risk assets and use the resulting net sum of weighted-risk assets in computing the denominator of the risk-based capital ratio.

[11] Long-term preferred stock with an original maturity of 20 years or more (including related surplus) will also qualify in this category as an element of tier 2. If the holder of such an instrument has a right to require the issuer to redeem, repay, or repurchase the instrument prior to the original stated maturity, maturity would be defined, for risk-based capital purposes, as the earliest possible date on which the holder can put the instrument back to the issuing bank.

the criteria set forth in 12 CFR 225, appendix B also qualify as unlimited elements of tier 2 capital. In accordance with that appendix, equity commitment notes issued prior to May 15, 1985, also qualify for inclusion in tier 2.

d. *Subordinated debt and intermediate-term preferred stock.* The aggregate amount of term subordinated debt (excluding mandatory convertible debt) and intermediate-term preferred stock that may be treated as supplementary capital is limited to 50 percent of tier 1 capital (net of goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of this appendix). Amounts in excess of these limits may be issued and, while not included in the ratio calculation, will be taken into account in the overall assessment of a bank's funding and financial condition.

Subordinated debt and intermediate-term preferred stock must have an original weighted average maturity of at least five years to qualify as supplementary capital. (If the holder has the option to require the issuer to redeem, repay, or repurchase the instrument prior to the original stated maturity, maturity would be defined, for risk-based capital purposes, as the earliest possible date on which the holder can put the instrument back to the issuing bank.)

In the case of subordinated debt, the instrument must be unsecured and must clearly state on its face that it is not a deposit and is not insured by a federal agency. To qualify as capital in banks, debt must be subordinated to general creditors and claims of depositors. Consistent with current regulatory requirements, if a state member bank wishes to redeem subordinated debt before the stated maturity, it must receive prior approval of the Federal Reserve.

e. *Discount of supplementary capital instruments.* As a limited-life capital instrument approaches maturity it begins to take on characteristics of a short-term obligation. For this reason, the outstanding amount of term subordinated debt and any long- or intermediate-life, or term, preferred stock eligible for inclusion in tier 2 is reduced, or discounted, as these instruments approach maturity: one-fifth of the original amount, less any redemptions, is excluded each year during the instrument's last five years before maturity.[12]

f. *Revaluation reserves.*

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

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

B. Deductions from Capital and Other Adjustments

Certain assets are deducted from a bank's capital for the purpose of calculating the risk-based capital ratio.[13] These assets include—

i. a. Goodwill—deducted from the sum of core capital elements

b. Certain identifiable intangible assets,

[12] For example, outstanding amounts of these instruments that count as supplementary capital include 100 percent of the outstanding amounts with remaining maturities of more than five years; 80 percent of outstanding amounts with remaining maturities of four to five years; 60 percent of outstanding amounts with remaining maturities of three to four years; 40 percent of outstanding amounts with remaining maturities of two to three years; 20 percent of outstanding amounts with remaining maturities of one to two years; and 0 percent of outstanding amounts with remaining maturities of less than one year. Such instruments with a remaining maturity of less than one year are excluded from tier 2 capital.

[13] Any assets deducted from capital in computing the numerator of the ratio are not included in weighted-risk assets in computing the denominator of the ratio.

that is, intangible assets other than goodwill—deducted from the sum of core capital elements in accordance with section II.B.1.b. of this appendix.

ii. investments in banking and finance subsidiaries that are not consolidated for accounting or supervisory purposes and, on a case-by-case basis, investments in other designated subsidiaries or associated companies at the discretion of the Federal Reserve—deducted from total capital components

iii. reciprocal holdings of capital instruments of banking organizations—deducted from total capital components

iv. deferred tax assets—portions are deducted from the sum of core capital elements in accordance with section II.B.4 of this appendix A.

1. *Goodwill and other intangible assets*

a. *Goodwill.* Goodwill is an intangible asset that represents the excess of the purchase price over the fair market value of identifiable assets acquired less liabilities assumed in acquisitions accounted for under the purchase method of accounting. State member banks generally have not been allowed to include goodwill in regulatory capital under current supervisory policies. Consistent with this policy, all goodwill in state member banks will be deducted from tier 1 capital.

b. *Other intangible assets.* i. 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 rights and purchased credit-card relationships, provided that, in the aggregate, the total amount of these assets included in capital does not exceed 50 percent of tier 1 capital. Purchased credit-card relationships are subject to a separate sublimit of 25 percent of tier 1 capital.[14]

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

iii. Banks must review the book value of all intangible assets at least quarterly and make adjustments to these values as necessary. The fair market value of mortgage-servicing rights and purchased credit-card relationships also must be determined at least quarterly. The fair market value generally shall be determined by applying an appropriate market discount rate to the expected future net cash flows. 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 market 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 rights and purchased credit-card relationships that a bank may include in capital shall be the *lesser* of 90 percent of their fair market 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 report). If

[14] Amounts of mortgage-servicing rights and purchased credit-card relationships in excess of these limitations, as well as all other identifiable intangible assets, including core deposit intangibles and favorable leaseholds, are to be deducted from a bank's core capital elements in determining tier 1 capital. However, identifiable intangible assets (other than mortgage-servicing rights 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.

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

vi. The treatment of identifiable intangible assets set forth in this section generally will be used in the calculation of a bank's capital ratios for supervisory and applications purposes. However, in making an overall assessment of a bank's capital adequacy for applications purposes, the Board may, if it deems appropriate, take into account the quality and composition of a bank's capital, together with the quality and value of its tangible and intangible assets.

vii. Consistent with long-standing Board policy, banks experiencing substantial growth, whether internally or by acquisition, are expected to maintain strong capital positions substantially above minimum supervisory levels, without significant reliance on intangible assets.

2. *Investments in certain subsidiaries.* The aggregate amount of investments in banking or finance subsidiaries[15] whose financial statements are not consolidated for accounting or bank regulatory reporting purposes will be deducted from a bank's total capital components.[16] Generally, investments for this purpose are defined as equity and debt capital investments and any other instruments that are deemed to be capital in the particular subsidiary.

Advances (that is, loans, extensions of credit, guarantees, commitments, or any other forms of credit exposure) to the subsidiary that are not deemed to be capital will generally not be deducted from a bank's capital. Rather, such advances generally will be included in the bank's consolidated assets and be assigned to the 100 percent risk category, unless such obligations are backed by recognized collateral or guarantees, in which case they will be assigned to the risk category appropriate to such collateral or guarantees. These advances may, however, also be deducted from the bank's capital if, in the judgment of the Federal Reserve, the risks stemming from such advances are comparable to the risks associated with capital investments or if the advances involve other risk factors that warrant such an adjustment to capital for supervisory purposes. These other factors could include, for example, the absence of collateral support.

Inasmuch as the assets of unconsolidated banking and finance subsidiaries are not fully reflected in a bank's consolidated total assets, such assets may be viewed as the equivalent of off-balance-sheet exposures since the operations of an unconsolidated subsidiary could expose the bank to considerable risk. For this reason, it is generally appropriate to view the capital resources invested in these unconsolidated entities as primarily supporting the risks inherent in these off-balance-sheet assets, and not generally available to support risks or absorb losses elsewhere in the bank.

The Federal Reserve may, on a case-by-case basis, also deduct from a bank's capital, investments in certain other subsidiaries in order to determine if the consolidated bank meets minimum supervisory capital requirements without reliance on the resources invested in such subsidiaries.

The Federal Reserve will not automatically deduct investments in other unconsolidated subsidiaries or investments in joint ventures and associated companies.[17] Nonetheless, the resources invested in these entities, like investments in unconsolidated banking and finance subsidiaries, support assets not consolidated with the rest of the bank's activities and, therefore, may not be generally available

[15] For this purpose, a banking and finance subsidiary generally is defined as any company engaged in banking or finance in which the parent institution holds directly or indirectly more than 50 percent of the outstanding voting stock, or which is otherwise controlled or capable of being controlled by the parent institution.

[16] An exception to this deduction would be made in the case of shares acquired in the regular course of securing or collecting a debt previously contracted in good faith. The requirements for consolidation are spelled out in the instructions to the call report.

[17] The definition of such entities is contained in the instructions to the commercial bank call report. Under regulatory reporting procedures, associated companies and joint ventures generally are defined as companies in which the bank owns 20 to 50 percent of the voting stock.

to support additional leverage or absorb losses elsewhere in the bank. Moreover, experience has shown that banks stand behind the losses of affiliated institutions, such as joint ventures and associated companies, in order to protect the reputation of the organization as a whole. In some cases, this has led to losses that have exceeded the investments in such organizations.

For this reason, the Federal Reserve will monitor the level and nature of such investments for individual banks and on a case-by-case basis may, for risk-based capital purposes, deduct such investments from total capital components, apply an appropriate risk-weighted capital charge against the bank's proportionate share of the assets of its associated companies, require a line-by-line consolidation of the entity (in the event that the bank's control over the entity makes it the functional equivalent of a subsidiary), or otherwise require the bank to operate with a risk-based capital ratio above the minimum.

In considering the appropriateness of such adjustments or actions, the Federal Reserve will generally take into account whether—

1. the bank has significant influence over the financial or managerial policies or operations of the subsidiary, joint venture, or associated company;
2. the bank is the largest investor in the affiliated company; or
3. other circumstances prevail that appear to closely tie the activities of the affiliated company to the bank.

3. *Reciprocal holdings of banking organizations' capital instruments.* Reciprocal holdings of banking organizations' capital instruments (that is, instruments that qualify as tier 1 or tier 2 capital)[18] will be deducted from a bank's total capital components for the purpose of determining the numerator of the risk-based capital ratio.

Reciprocal holdings are cross-holdings resulting from formal or informal arrangements in which two or more banking organizations swap, exchange, or otherwise agree to hold each other's capital instruments. Generally, deductions will be limited to intentional cross-holdings. At present, the Board does not intend to require banks to deduct nonreciprocal holdings of such capital instruments.[19]

4. *Deferred-tax assets.* The amount of deferred-tax assets that are 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,[20] 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 all identifiable intangible assets other than mortgage-servicing rights 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

[18] See 12 CFR 225, appendix A for instruments that qualify as tier 1 and tier 2 capital for bank holding companies.

[19] Deductions of holdings of capital securities also would not be made in the case of interstate "stake out" investments that comply with the Board's policy statement on nonvoting equity investments, 12 CFR 225.143. In addition, holdings of capital instruments issued by other banking organizations but taken in satisfaction of debts previously contracted would be exempt from any deduction from capital. The Board intends to monitor nonreciprocal holdings of other banking organizations' capital instruments and to provide information on such holdings to the Basle Supervisors' Committee as called for under the Basle capital framework.

[20] 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.

temporary differences, but, for banks that have a parent, this may not exceed the amount the bank could reasonably expect its parent to refund.

III. Procedures for Computing Weighted-Risk Assets and Off-Balance-Sheet Items

A. Procedures

Assets and credit-equivalent amounts of off-balance-sheet items of state member banks are assigned to one of several broad risk categories, according to the obligor, or, if relevant, the guarantor or the nature of the collateral. The aggregate dollar value of the amount in each category is then multiplied by the risk weight associated with that category. The resulting weighted values from each of the risk categories are added together, and this sum is the bank's total weighted-risk assets that comprise the denominator of the risk-based capital ratio. Attachment I provides a sample calculation.

Risk weights for all off-balance-sheet items are determined by a two-step process. First, the "credit-equivalent amount" of off-balance-sheet items is determined, in most cases by multiplying the off-balance-sheet item by a credit-conversion factor. Second, the credit-equivalent amount is treated like any balance-sheet asset and generally is assigned to the appropriate risk category according to the obligor, or, if relevant, the guarantor or the nature of the collateral.

In general, if a particular item qualifies for placement in more than one risk category, it is assigned to the category that has the lowest risk weight. A holding of a U.S. municipal revenue bond that is fully guaranteed by a U.S. bank, for example, would be assigned the 20 percent risk weight appropriate to claims guaranteed by U.S. banks, rather than the 50 percent risk weight appropriate to U.S. municipal revenue bonds.[21]

The terms "claims" and "securities" used in the context of the discussion of risk weights, unless otherwise specified, refer to loans or debt obligations of the entity on whom the claim is held. Assets in the form of stock or equity holdings in commercial or financial firms are assigned to the 100 percent risk category, unless some other treatment is explicitly permitted.

B. Collateral, Guarantees, and Other Considerations

1. *Collateral.* The only forms of collateral that are formally recognized by the risk-based capital framework are cash on deposit in the bank; securities issued or guaranteed by the central governments of the OECD-based group of countries,[22] U.S. government agencies, or U.S. government–sponsored agencies;

[21] An investment in shares of a fund whose portfolio consists solely of various securities or money market instruments that, if held separately, would be assigned to different risk categories, is generally assigned to the risk category appropriate to the highest risk-weighted security or instrument that the fund is permitted to hold in accordance with its stated investment objectives. However, in no case will indirect holdings through shares in such funds be assigned to the zero percent risk category. For example, if a fund is permitted to hold U.S. Treasuries and commercial paper, shares in that fund would generally be assigned the 100 percent risk weight appropriate to commercial paper, regardless of the actual composition of the fund's investments at any particular time. Shares in a fund that may invest only in U.S. Treasury securities would generally be assigned to the 20 percent risk category. If, in order to maintain a necessary degree of short-term liquidity, a fund is permitted to hold an insignificant amount of its assets in short-term, highly liquid securities of superior credit quality that do not qualify for a preferential risk weight, such securities will generally not be taken into account in determining the risk category into which the bank's holding in the overall fund should be assigned. Regardless of the composition of the fund's securities, if the fund engages in any activities that appear speculative in nature (for example, use of futures, forwards, or option contracts for purposes other than to reduce interest-rate risk) or has any other characteristics that are inconsistent with the preferential risk weighting assigned to the fund's investments, holdings in the fund will be assigned to the 100 percent risk category. During the examination process, the treatment of shares in such funds that are assigned to a lower risk weight will be subject to examiner review to ensure that they have been assigned an appropriate risk weight.

[22] The OECD-based group of countries comprises all full members of the Organization for Economic Cooperation and Development (OECD), as well as countries that have concluded special lending arrangements with the International Monetary Fund (IMF) associated with the Fund's General Arrangements to Borrow. The OECD includes the following countries: Australia, Austria, Belgium, Canada, Denmark, the Federal Republic of Germany, Finland, France, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. Saudi Arabia has concluded special lending arrangements with the IMF associated with the Fund's General Arrangements to Borrow.

and securities issued by multilateral lending institutions or regional development banks. Claims fully secured by such collateral generally are assigned to the 20 percent risk-weight category. Collateralized transactions meeting all the conditions described in section III.C.1. may be assigned a zero percent risk weight.

With regard to collateralized claims that may be assigned to the 20 percent risk-weight category, the extent to which qualifying securities are recognized as collateral is determined by their current market value. If such a claim is only partially secured, that is, the market value of the pledged securities is less than the face amount of a balance-sheet asset or an off-balance-sheet item, the portion that is covered by the market value of the qualifying collateral is assigned to the 20 percent risk category, and the portion of the claim that is not covered by collateral in the form of cash or a qualifying security is assigned to the risk category appropriate to the obligor or, if relevant, the guarantor. For example, to the extent that a claim on a private-sector obligor is collateralized by the current market value of U.S. government securities, it would be placed in the 20 percent risk category, and the balance would be assigned to the 100 percent risk category.

2. *Guarantees.* Guarantees of the OECD and non-OECD central governments, U.S. government agencies, U.S. government–sponsored agencies, state and local governments of the OECD-based group of countries, multilateral lending institutions and regional development banks, U.S. depository institutions, and foreign banks are also recognized. If a claim is partially guaranteed, that is, coverage of the guarantee is less than the face amount of a balance-sheet asset or an off-balance-sheet item, the portion that is not fully covered by the guarantee is assigned to the risk category appropriate to the obligor or, if relevant, to any collateral. The face amount of a claim covered by two types of guarantees that have different risk weights, such as a U.S. government guarantee and a state guarantee, is to be apportioned between the two risk categories appropriate to the guarantors.

The existence of other forms of collateral or guarantees that the risk-based capital framework does not formally recognize may be taken into consideration in evaluating the risks inherent in a bank's loan portfolio—which, in turn, would affect the overall supervisory assessment of the bank's capital adequacy.

3. *Mortgage-backed securities.* Mortgage-backed securities, including pass-throughs and collateralized mortgage obligations (but not stripped mortgage-backed securities), that are *issued* or *guaranteed* by a U.S. government agency or U.S. government–sponsored agency are assigned to the risk-weight category appropriate to the issuer or guarantor. Generally, a privately issued mortgage-backed security meeting certain criteria set forth in the accompanying footnote[23] is treated as essentially an indirect holding of the underlying assets, and assigned to the same risk category as the underlying assets, but in no case to the zero percent risk category. Privately issued mortgage-backed securities whose structures do not qualify them to be regarded as indirect holdings of the underlying assets are assigned to the 100 percent risk category. During the examination process, privately issued mortgage-backed securities that are assigned to a lower risk-weight category will be subject to examiner review to ensure that they meet the appropriate criteria.

While the risk category to which mortgage-backed securities are assigned will generally be based upon the issuer or guarantor or, in

[23] A privately issued mortgage-backed security may be treated as an indirect holding of the underlying assets provided that (1) the underlying assets are held by an independent trustee and the trustee has a first priority, perfected security interest in the underlying assets on behalf of the holders of the security; (2) either the holder of the security has an undivided pro rata ownership interest in the underlying mortgage assets or the trust or single-purpose entity (or conduit) that issues the security has no liabilities unrelated to the issued securities; (3) the security is structured such that the cash flow from the underlying assets in all cases fully meets the cash flow requirements of the security without undue reliance on any reinvestment income; and (4) there is no material reinvestment risk associated with any funds awaiting distribution to the holders of the security. In addition, if the underlying assets of a mortgage-backed security are composed of more than one type of asset, for example, U.S. government–sponsored agency securities and privately issued pass-through securities that qualify for the 50 percent risk category, the entire mortgage-backed security is generally assigned to the category appropriate to the highest risk-weighted asset underlying the issue. Thus, in this example, the security would receive the 50 percent risk weight appropriate to the privately issued pass-through securities.

the case of privately issued mortgage-backed securities, the assets underlying the security, any class of a mortgage-backed security that can absorb more than its pro rata share of loss without the whole issue being in default (for example, a so-called subordinated class or residual interest), is assigned to the 100 percent risk category. Furthermore, all stripped mortgage-backed securities, including interest-only strips (IOs), principal-only strips (POs), and similar instruments are also assigned to the 100 percent risk-weight category, regardless of the issuer or guarantor.

4. *Maturity.* Maturity is generally not a factor in assigning items to risk categories with the exception of claims on non-OECD banks, commitments, and interest-rate and foreign-exchange-rate contracts. Except for commitments, short-term is defined as one year or less *remaining* maturity and long-term is defined as over one year *remaining* maturity. In the case of commitments, short-term is defined as one year or less *original* maturity and long-term is defined as over one year *original* maturity.[24]

5. *Small-business loans and leases on personal property transferred with recourse.*

a. Notwithstanding other provisions of this appendix A, a qualifying bank that has transferred small-business loans and leases on personal property (small-business obligations) with recourse shall include in weighted-risk assets only the amount of retained recourse, provided two conditions are met. First, the transaction must be treated as a sale under GAAP and, second, the bank must establish pursuant to GAAP a noncapital reserve sufficient to meet the bank's reasonably estimated liability under the recourse arrangement. Only loans and leases to businesses that meet the criteria for a small-business concern established by the Small Business Administration under section 3(a) of the Small Business Act are eligible for this capital treatment.

b. For purposes of this appendix A, a bank is qualifying if it meets the criteria set forth in the Board's prompt-corrective-action regulation (12 CFR 208.30) for well capitalized or, by order of the Board, adequately capitalized. For purposes of determining whether a bank meets the criteria, its capital ratios must be calculated without regard to the preferential capital treatment for transfers of small-business obligations with recourse specified in section III.B.5.a. of this appendix A. The total outstanding amount of recourse retained by a qualifying bank on transfers of small-business obligations receiving the preferential capital treatment cannot exceed 15 percent of the bank's total risk-based capital. By order, the Board may approve a higher limit.

c. If a bank ceases to be qualifying or exceeds the 15 percent capital limitation, the preferential capital treatment will continue to apply to any transfers of small-business obligations with recourse that were consummated during the time that the bank was qualifying and did not exceed the capital limit.

d. The risk-based capital ratios of the bank shall be calculated without regard to the preferential capital treatment for transfers of small-business obligations with recourse specified in section III.B.5.a. of this appendix A for purposes of—

i. determining whether a bank is adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized under prompt corrective action (12 CFR 208.33(b)); and

ii. reclassifying a well-capitalized bank to adequately capitalized and requiring an adequately capitalized bank to comply with certain mandatory or discretionary supervisory actions as if the bank were in the next lower prompt-corrective-action capital category (12 CFR 208.33(c)).

C. Risk Weights

Attachment III contains a listing of the risk categories, a summary of the types of assets assigned to each category and the weight associated with each category, that is, 0 percent, 20 percent, 50 percent, and 100 percent. A brief explanation of the components of each category follows.

[24] Through year-end 1992, remaining, rather than original, maturity may be used for determining the maturity of commitments.

1. *Category 1: zero percent.* This category includes cash (domestic and foreign) owned and held in all offices of the bank or in transit and gold bullion held in the bank's own vaults or in another bank's vaults on an allocated basis, to the extent it is offset by gold bullion liabilities.[25] The category also includes all direct claims (including securities, loans, and leases) on, and the portions of claims that are directly and unconditionally guaranteed by, the central governments[26] of the OECD countries and U.S. government agencies,[27] as well as all direct local currency claims on, and the portions of local currency claims that are directly and unconditionally guaranteed by, the central governments of non-OECD countries, to the extent that the bank has liabilities booked in that currency. A claim is not considered to be unconditionally guaranteed by a central government if the validity of the guarantee is dependent upon some affirmative action by the holder or a third party. Generally, securities guaranteed by the U.S. government or its agencies that are actively traded in financial markets, such as GNMA securities, are considered to be unconditionally guaranteed.

This category also includes claims collateralized by cash on deposit in the bank or by securities issued or guaranteed by OECD central governments or U.S. government agencies for which a positive margin of collateral is maintained on a daily basis, fully taking into account any change in the bank's exposure to the obligor or counterparty under a claim in relation to the market value of the collateral held in support of that claim.

2. *Category 2: 20 percent.* This category includes cash items in the process of collection, both foreign and domestic; short-term claims (including demand deposits) on, and the portions of short-term claims that are guaranteed[28] by, U.S. depository institutions[29] and foreign banks;[30] and long-term claims on, and the portions of long-term claims that are guaranteed by, U.S. depository institutions and OECD banks.[31]

This category also includes the portions of claims that are conditionally guaranteed by OECD central governments and U.S. government agencies, as well as the portions of local currency claims that are conditionally guaran-

[25] All other holdings of bullion are assigned to the 100 percent risk category.

[26] A central government is defined to include departments and ministries, including the central bank, of the central government. The U.S. central bank includes the 12 Federal Reserve Banks, and the stock held in these banks as a condition of membership is assigned to the zero percent risk category. The definition of central government does not include state, provincial, or local governments; or commercial enterprises owned by the central government. In addition, it does not include local government entities or commercial enterprises whose obligations are guaranteed by the central government, although any claims on such entities guaranteed by central governments are placed in the same general risk category as other claims guaranteed by central governments. OECD central governments are defined as central governments of the OECD-based group of countries; non-OECD central governments are defined as central governments of countries that do not belong to the OECD-based group of countries.

[27] A U.S. government agency is defined as an instrumentality of the U.S. government whose obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. government. Such agencies include the Government National Mortgage Association (GNMA), the Veterans Administration (VA), the Federal Housing Administration (FHA), the Export-Import Bank (Exim Bank), the Overseas Private Investment Corporation (OPIC), the Commodity Credit Corporation (CCC), and the Small Business Administration (SBA).

[28] Claims guaranteed by U.S. depository institutions and foreign banks include risk participations in both banker's acceptances and standby letters of credit, as well as participations in commitments, that are conveyed to other U.S. depository institutions or foreign banks.

[29] U.S. depository institutions are defined to include branches (foreign and domestic) of federally insured banks and depository institutions chartered and headquartered in the 50 states of the United States, the District of Columbia, Puerto Rico, and U.S. territories and possessions. The definition encompasses banks, mutual or stock savings banks, savings or building and loan associations, cooperative banks, credit unions, and international banking facilities of domestic banks. U.S.-chartered depository institutions owned by foreigners are also included in the definition. However, branches and agencies of foreign banks located in the U.S., as well as all bank holding companies, are excluded.

[30] Foreign banks are distinguished as either OECD banks or non-OECD banks. OECD banks include banks and their branches (foreign and domestic) organized under the laws of countries (other than the U.S.) that belong to the OECD-based group of countries. Non-OECD banks include banks and their branches (foreign and domestic) organized under the laws of countries that do not belong to the OECD-based group of countries. For this purpose, a bank is defined as an institution that engages in the business of banking; is recognized as a bank by the bank supervisory or monetary authorities of the country of its organization or principal banking operations; receives deposits to a substantial extent in the regular course of business; and has the power to accept demand deposits.

[31] Long-term claims on, or guaranteed by, non-OECD banks and all claims on bank holding companies are assigned to the 100 percent risk category, as are holdings of bank-issued securities that qualify as capital of the issuing banks.

teed by non-OECD central governments, to the extent that the bank has liabilities booked in that currency. In addition, this category also includes claims on, and the portions of claims that are guaranteed by, U.S. government–sponsored[32] agencies and claims on, and the portions of claims guaranteed by, the International Bank for Reconstruction and Development (World Bank), the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Investment Bank, the European Bank for Reconstruction and Development, the Nordic Investment Bank, and other multilateral lending institutions or regional development banks in which the U.S. government is a shareholder or contributing member. General obligation claims on, or portions of claims guaranteed by the full faith and credit of, states or other political subdivisions of the United States or other countries of the OECD-based group are also assigned to this category.[33]

This category also includes the portions of claims (including repurchase transactions) collateralized by cash on deposit in the bank or by securities issued or guaranteed by OECD central governments or U.S. government agencies that do not qualify for the zero percent risk-weight category; collateralized by securities issued or guaranteed by U.S. government–sponsored agencies; or collateralized by securities issued by multilateral lending institutions or regional development banks in which the U.S. government is a shareholder or contributing member.

3. *Category 3: 50 percent.* This category includes loans fully secured by first liens[34] on one- to four-family residential properties, either owner-occupied or rented, or on multifamily residential properties,[35] that meet certain criteria.[36] Loans included in this category must have been made in accordance with prudent underwriting standards;[37] be performing in accordance with their original terms; and not be 90 days or more past due or carried in

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[32] For this purpose, U.S. government–sponsored agencies are defined as agencies originally established or chartered by the federal government to serve public purposes specified by the U.S. Congress but whose obligations are *not explicitly* guaranteed by the full faith and credit of the U.S. government. These agencies include the Federal Home Loan Mortgage Corporation (FHLMC), the Federal National Mortgage Association (FNMA), the Farm Credit System, the Federal Home Loan Bank System, and the Student Loan Marketing Association (SLMA). Claims on U.S. government–sponsored agencies include capital stock in a Federal Home Loan Bank that is held as a condition of membership in that Bank.

[33] Claims on, or guaranteed by, states or other political subdivisions of countries that do not belong to the OECD-based group of countries are placed in the 100 percent risk category.

[34] If a bank holds the first and junior lien(s) on a residential property and no other party holds an intervening lien, the transaction is treated as a single loan secured by a first lien for the purpose of determining the loan-to-value ratio.

[35] Loans that qualify as loans secured by one- to four-family residential properties or multifamily residential properties are listed in the instructions to the commercial bank call report. In addition, for risk-based capital purposes, loans secured by one- to four-family residential properties include loans to builders with substantial project equity for the construction of one- to four-family residences that have been presold under firm contracts to purchasers who have obtained firm commitments for permanent qualifying mortgage loans and have made substantial earnest-money deposits.

The instructions to the call report also discuss the treatment of loans, including multifamily housing loans, that are sold subject to a pro rata loss-sharing arrangement. Such an arrangement should be treated by the selling bank as sold (and excluded from balance-sheet assets) to the extent that the sales agreement provides for the purchaser of the loan to share in any loss incurred on the loan on a pro rata basis with the selling bank. In such a transaction, from the standpoint of the selling bank, the portion of the loan that is treated as sold is not subject to the risk-based capital standards. In connection with sales of multifamily housing loans in which the purchaser of a loan shares in any loss incurred on the loan with the selling institution on other than a pro rata basis, these other loss-sharing arrangements are taken into account for purposes of determining the extent to which such loans are treated by the selling bank as sold (and excluded from balance-sheet assets) under the risk-based capital framework in the same manner as prescribed for reporting purposes in the instructions to the call report.

[36] Residential property loans that do not meet all the specified criteria or that are made for the purpose of speculative property development are placed in the 100 percent risk category.

[37] Prudent underwriting standards include a conservative ratio of the current loan balance to the value of the property. In the case of a loan secured by multifamily residential property, the loan-to-value ratio is not conservative if it exceeds 80 percent (75 percent if the loan is based on a floating interest rate). Prudent underwriting standards also dictate that a loan-to-value ratio used in the case of originating a loan to acquire a property would not be deemed conservative unless the value is based on the lower of the acquisition cost of the property or appraised (or if appropriate, evaluated) value. Otherwise, the loan-to-value ratio generally would be based upon the value of the property as determined by the most current appraisal or, if appropriate, the most current evaluation. All appraisals must be made in a manner consistent with the federal banking agencies' real estate appraisal regulations and guidelines and with the bank's own appraisal guidelines.

nonaccrual status. The following additional criteria must also be applied to a loan secured by a multifamily residential property that is included in this category: all principal and interest payments on the loan must have been made on time for at least the year preceding placement in this category, or in the case where the existing property owner is refinancing a loan on that property, all principal and interest payments on the loan being refinanced must have been made on time for at least the year preceding placement in this category; amortization of the principal and interest must occur over a period of not more that 30 years and the minimum original maturity for repayment of principal must not be less than 7 years; and the annual net operating income (before debt service) generated by the property during its most recent fiscal year must not be less than 120 percent of the loan's current annual debt service (115 percent if the loan is based on a floating interest rate) or, in the case of a cooperative or other not-for-profit housing project, the property must generate sufficient cash flow to provide comparable protection to the institution. Also included in this category are privately issued mortgage-backed securities provided that (1) the structure of the security meets the criteria described in section III(B)(3) above; (2) if the security is backed by a pool of conventional mortgages, on one- to four-family residential or multifamily residential properties, *each* underlying mortgage meets the criteria described above in this section for eligibility for the 50 percent risk category at the time the pool is originated; (3) if the security is backed by privately issued mortgage-backed securities, *each* underlying security qualifies for the 50 percent risk category; and (4) if the security is backed by a pool of multifamily residential mortgages, principal and interest payments on the security are not 30 days or more past due. Privately issued mortgage-backed securities that do not meet these criteria or that do not qualify for a lower risk weight are generally assigned to the 100 percent risk category.

Also assigned to this category are *revenue* (nongeneral obligation) bonds or similar obligations, including loans and leases, that are obligations of states or other political subdivisions of the U.S. (for example, municipal revenue bonds) or other countries of the OECD-based group, but for which the government entity is committed to repay the debt with revenues from the specific projects financed, rather than from general tax funds.

Credit-equivalent amounts of derivative contracts involving standard risk obligors (that is, obligors whose loans or debt securities would be assigned to the 100 percent risk category) are included in the 50 percent category, unless they are backed by collateral or guarantees that allow them to be placed in a lower risk category.

4. *Category 4: 100 percent.* All assets not included in the categories above are assigned to this category, which comprises standard risk assets. The bulk of the assets typically found in a loan portfolio would be assigned to the 100 percent category.

This category includes long-term claims on, or guaranteed by, non-OECD banks, and all claims on non-OECD central governments that entail some degree of transfer risk.[38] This category also includes all claims on foreign and domestic private-sector obligors not included in the categories above (including loans to nondepository financial institutions and bank holding companies); claims on commercial firms owned by the public sector; customer liabilities to the bank on acceptances outstanding involving standard risk claims;[39] investments in fixed assets, premises, and other real estate owned; common and preferred stock of corporations, including stock acquired for debts previously contracted; commercial and consumer loans (except those assigned to lower risk categories due to recognized guarantees or collateral and loans for residential property that qualify for a lower risk weight); mortgage-backed securities that do not meet

[38] Such assets include all nonlocal currency claims on, or guaranteed by, non-OECD central governments and those portions of local currency claims on, or guaranteed by, non-OECD central governments that exceed the local currency liabilities held by the bank.

[39] Customer liabilities on acceptances outstanding involving nonstandard risk claims, such as claims on U.S. depository institutions, are assigned to the risk category appropriate to the identity of the obligor or, if relevant, the nature of the collateral or guarantees backing the claims. Portions of acceptances conveyed as risk participations to U.S. depository institutions or foreign banks are assigned to the 20 percent risk category appropriate to short-term claims guaranteed by U.S. depository institutions and foreign banks.

criteria for assignment to a lower risk weight (including any classes of mortgage-backed securities that can absorb more than their pro rata share of loss without the whole issue being in default); and all stripped mortgage-backed and similar securities.

Also included in this category are industrial development bonds and similar obligations issued under the auspices of states or political subdivisions of the OECD-based group of countries for the benefit of a private party or enterprise where that party or enterprise, not the government entity, is obligated to pay the principal and interest, and all obligations of states or political subdivisions of countries that do not belong to the OECD-based group.

The following assets also are assigned a risk weight of 100 percent if they have not been deducted from capital: investments in unconsolidated companies, joint ventures, or associated companies; instruments that qualify as capital issued by other banking organizations; and any intangibles, including those that may have been grandfathered into capital.

D. Off-Balance-Sheet Items

The face amount of an off-balance-sheet item is incorporated into the risk-based capital ratio by multiplying it by a credit-conversion factor. The resultant credit-equivalent amount is assigned to the appropriate risk category according to the obligor, or, if relevant, the guarantor or the nature of the collateral.[40] Attachment IV sets forth the conversion factors for various types of off-balance-sheet items.

1. *Items with a 100 percent conversion factor.*
   a. A 100 percent conversion factor applies to direct credit substitutes, which include guarantees, or equivalent instruments, backing financial claims, such as outstanding securities, loans, and other financial liabilities, or that back off-balance-sheet items that require capital under the risk-based capital framework. Direct credit substitutes include, for example, financial standby letters of credit, or other equivalent irrevocable undertakings or surety arrangements, that guarantee repayment of financial obligations such as commercial paper, tax-exempt securities, commercial or individual loans or debt obligations, or standby or commercial letters of credit. Direct credit substitutes also include the acquisition of risk participations in banker's acceptances and standby letters of credit, since both of these transactions, in effect, constitute a guarantee by the acquiring bank that the underlying account party (obligor) will repay its obligation to the originating, or issuing, institution.[41] (Standby letters of credit that are performance related are discussed below and have a credit-conversion factor of 50 percent.)

   b. The full amount of a direct credit substitute is converted at 100 percent and the resulting credit-equivalent amount is assigned to the risk category appropriate to the obligor or, if relevant, the guarantor or the nature of the collateral. In the case of a direct credit substitute in which a risk participation[42] has been conveyed, the full amount is still converted at 100 percent. However, the credit-equivalent amount that has been conveyed is assigned to whichever risk category is lower: the risk category appropriate to the obligor, after giving effect to any relevant guarantees or collateral, or the risk category appropriate to the institution acquiring the participation. Any remainder is assigned to the risk category appropriate to the obligor, guarantor, or collateral. For example, the portion of a direct credit substitute conveyed as a risk participation to a U.S. domestic depository institution or foreign bank is assigned to the risk category appropriate to claims guaranteed by those institutions, that is, the 20

[40] The sufficiency of collateral and guarantees for off-balance-sheet items is determined by the market value of the collateral or the amount of the guarantee in relation to the face amount of the item, except for derivative contracts, for which this determination is generally made in relation to the credit-equivalent amount. Collateral and guarantees are subject to the same provisions noted under section III.B. of this appendix A.

[41] Credit-equivalent amounts of acquisitions of risk participations are assigned to the risk category appropriate to the account-party obligor, or, if relevant, the nature of the collateral or guarantees.

[42] That is, a participation in which the originating bank remains liable to the beneficiary for the full amount of the direct credit substitute if the party that has acquired the participation fails to pay when the instrument is drawn.

percent risk category.[43] This approach recognizes that such conveyances replace the originating bank's exposure to the obligor with an exposure to the institutions acquiring the risk participations.[44]

c. In the case of direct credit substitutes that take the form of a syndication as defined in the instructions to the commercial bank call report, that is, where each bank is obligated only for its pro rata share of the risk and there is no recourse to the originating bank, each bank will only include its pro rata share of the direct credit substitute in its risk-based capital calculation.

d. Financial standby letters of credit are distinguished from loan commitments (discussed below) in that standbys are irrevocable obligations of the bank to pay a third-party beneficiary when a customer (account party) *fails to repay* an outstanding loan or debt instrument (direct credit substitute). Performance standby letters of credit (performance bonds) are irrevocable obligations of the bank to pay a third-party beneficiary when a customer (account party) *fails to perform* some other contractual nonfinancial obligation.

e. The distinguishing characteristic of a standby letter of credit for risk-based capital purposes is the combination of irrevocability with the fact that funding is triggered by some failure to repay or perform an obligation. Thus, any commitment (by whatever name) that involves an *irrevocable* obligation to make a payment to the customer or to a third party in the event the customer *fails to repay* an outstanding debt obligation or *fails to perform* a contractual obligation is treated, for risk-based capital purposes, as respectively, a financial guarantee standby letter of credit or a performance standby.

f. A loan commitment, on the other hand, involves an obligation (with or without a material adverse change or similar clause) of the bank to fund its customer *in the normal course* of business should the customer seek to draw down the commitment.

g. Sale and repurchase agreements and asset sales with recourse (to the extent not included on the balance sheet) and forward agreements also are converted at 100 percent. The risk-based capital definition of the sale of assets with recourse, including the sale of one- to four-family residential mortgages, is the same as the definition contained in the instructions to the commercial bank call report. Accordingly, the entire amount of any assets transferred with recourse that are not already included on the balance sheet, including pools of one- to four-family residential mortgages, are to be converted at 100 percent and assigned to the risk weight appropriate to the obligor, or if relevant, the nature of any collateral or guarantees. The terms of a transfer of assets with recourse may contractually limit the amount of the institutions's liability to an amount less than the effective risk-based capital requirement for the assets being transferred with recourse. If such a transaction (including one that is reported as a financing, i.e., the assets are not removed from the balance sheet) meets the criteria for sales treatment under GAAP, the amount of total capital required is equal to the maximum amount of loss possible under the recourse provision. If the transaction is also treated as a sale for regulatory reporting purposes, then the required amount of capital may be reduced by the balance of any associated non–capital liability account established pursuant to GAAP to cover estimated probable losses under the recourse provision. So-called loan strips (that is, short-term advances sold under long-term commitments without direct recourse) are defined in the instructions to the commercial bank call report and for risk-based capital purposes as assets sold with recourse.

h. Forward agreements are legally binding contractual obligations to purchase assets with *certain* drawdown at a specified future date. Such obligations include forward purchases, forward forward deposits placed,[45]

[43] Risk participations with a remaining maturity of over one year that are conveyed to non-OECD banks are to be assigned to the 100 percent risk category, unless a lower risk category is appropriate to the obligor, guarantor, or collateral.

[44] A risk participation in banker's acceptances conveyed to other institutions is also assigned to the risk category appropriate to the institution acquiring the participation or, if relevant, the guarantor or nature of the collateral.

[45] Forward forward deposits accepted are treated as interest-rate contracts.

and partly paid shares and securities; they do not include commitments to make residential mortgage loans or forward foreign-exchange contracts.

i. Securities lent by a bank are treated in one of two ways, depending upon whether the lender is at risk of loss. If a bank, as agent for a customer, lends the customer's securities and does not indemnify the customer against loss, then the transaction is excluded from the risk-based capital calculation. If, alternatively, a bank lends its own securities or, acting as agent for a customer, lends the customer's securities and indemnifies the customer against loss, the transaction is converted at 100 percent and assigned to the risk-weight category appropriate to the obligor, to any collateral delivered to the lending bank, or, if applicable, to the independent custodian acting on the lender's behalf. Where a bank is acting as agent for a customer in a transaction involving the lending or sale of securities that is collateralized by cash delivered to the bank, the transaction is deemed to be collateralized by cash on deposit in the bank for purposes of determining the appropriate risk-weight category, provided that any indemnification is limited to no more than the difference between the market value of the securities and the cash collateral received and any reinvestment risk associated with that cash collateral is borne by the customer.

2. *Items with a 50 percent conversion factor.* Transaction-related contingencies are converted at 50 percent. Such contingencies include bid bonds, performance bonds, warranties, standby letters of credit related to particular transactions, and performance standby letters of credit, as well as acquisitions of risk participations in performance standby letters of credit. Performance standby letters of credit represent obligations backing the performance of nonfinancial or commercial contracts or undertakings. To the extent permitted by law or regulation, performance standby letters of credit include arrangements backing, among other things, subcontractors' and suppliers' performance, labor and materials contracts, and construction bids.

The unused portion of commitments with an *original* maturity exceeding one year,[46] including underwriting commitments, and commercial and consumer credit commitments also are converted at 50 percent. Original maturity is defined as the length of time between the date the commitment is issued and the earliest date on which (1) the bank can, at its option, unconditionally (without cause) cancel the commitment[47] *and* (2) the bank is scheduled to (and as a normal practice actually does) review the facility to determine whether or not it should be extended. Such reviews must continue to be conducted at least annually for such a facility to qualify as a short-term commitment.

Commitments are defined as any legally binding arrangements that obligate a bank to extend credit in the form of loans or leases; to purchase loans, securities, or other assets; or to participate in loans and leases. They also include overdraft facilities, revolving credit, home equity and mortgage lines of credit, and similar transactions. Normally, commitments involve a written contract or agreement and a commitment fee, or some other form of consideration. Commitments are included in weighted-risk assets regardless of whether they contain "material adverse change" clauses or other provisions that are intended to relieve the issuer of its funding obligation under certain conditions. In the case of commitments structured as syndications, where the bank is obligated solely for its pro rata share, only the bank's proportional share of the syndicated commitment is taken into account in calculating the risk-based capital ratio.

Facilities that are unconditionally cancellable (without cause) at any time by the bank are not deemed to be commitments, provided the bank makes a separate credit decision before each drawing under the facility. Commitments with an original maturity of one year or

[46] Through year-end 1992, remaining maturity may be used for determining the maturity of off-balance-sheet loan commitments; thereafter, original maturity must be used.

[47] In the case of consumer home equity or mortgage lines of credit secured by liens on one- to four-family residential properties, the bank is deemed able to unconditionally cancel the commitment for the purpose of this criterion if, at its option, it can prohibit additional extensions of credit, reduce the credit line, and terminate the commitment to the full extent permitted by relevant federal law.

less are deemed to involve low risk and, therefore, are not assessed a capital charge. Such short-term commitments are defined to include the unused portion of lines of credit on retail credit cards and related plans (as defined in the instructions to the commercial bank call report) if the bank has the unconditional right to cancel the line of credit at any time, in accordance with applicable law.

Once a commitment has been converted at 50 percent, any portion that has been conveyed to U.S. depository institutions or OECD banks as participations in which the originating bank retains the full obligation to the borrower if the participating bank fails to pay when the instrument is drawn, is assigned to the 20 percent risk category. This treatment is analogous to that accorded to conveyances of risk participations in standby letters of credit. The acquisition of a participation in a commitment by a bank is converted at 50 percent and assigned to the risk category appropriate to the account-party obligor or, if relevant, the nature of the collateral or guarantees.

Revolving underwriting facilities (RUFs), note issuance facilities (NIFs), and other similar arrangements also are converted at 50 percent regardless of maturity. These are facilities under which a borrower can issue on a revolving basis short-term paper in its own name, but for which the underwriting banks have a legally binding commitment either to purchase any notes the borrower is unable to sell by the rollover date or to advance funds to the borrower.

3. *Items with a 20 percent conversion factor.* Short-term, self-liquidating trade-related contingencies which arise from the movement of goods are converted at 20 percent. Such contingencies generally include commercial letters of credit and other documentary letters of credit collateralized by the underlying shipments.

4. *Items with a zero percent conversion factor.* These include unused portions of commitments with an original maturity of one year or less,[48] or which are unconditionally cancellable at any time, provided a separate credit decision is made before each drawing under the facility. Unused portions of lines of credit on retail credit cards and related plans are deemed to be short-term commitments if the bank has the unconditional right to cancel the line of credit at any time, in accordance with applicable law.

[48] Through year-end 1992, remaining maturity may be used for determining term to maturity for off-balance-sheet loan commitments; thereafter, original maturity must be used.

E. Derivative Contracts (Interest-Rate, Exchange-Rate, Commodity- (Including Precious Metals) and Equity-Linked Contracts)

1. *Scope.* Credit-equivalent amounts are computed for each of the following off-balance-sheet derivative contracts:

a. Interest-rate contracts. These include single-currency interest-rate swaps, basis swaps, forward rate agreements, interest-rate options purchased (including caps, collars, and floors purchased), and any other instrument linked to interest rates that gives rise to similar credit risks (including when-issued securities and forward forward deposits accepted).

b. Exchange-rate contracts. These include cross-currency interest-rate swaps, forward foreign-exchange contracts, currency options purchased, and any other instrument linked to exchange rates that gives rise to similar credit risks.

c. Equity derivative contracts. These include equity-linked swaps, equity-linked options purchased, forward equity-linked contracts, and any other instrument linked to equities that gives rise to similar credit risks.

d. Commodity (including precious metal) derivative contracts. These include commodity-linked swaps, commodity-linked options purchased, forward commodity-linked contracts, and any other instrument linked to commodities that gives rise to similar credit risks.

e. Exceptions. Exchange-rate contracts with an original maturity of 14 or fewer calendar days and derivative contracts traded on exchanges that require daily receipt and payment of cash-variation margin may be excluded from the risk-based ratio calculation. Gold contracts are accorded the same treatment as exchange-rate contracts except that gold contracts with an original maturity of 14 or fewer calendar days are included in the risk-based ratio calculation. Over-the-counter options purchased are included and treated in the same way as other derivative contracts.

2. *Calculation of credit-equivalent amounts.*

a. The credit-equivalent amount of a derivative contract that is not subject to a qualifying bilateral netting contract in accordance with section III.E.3. of this appendix A is equal to the sum of (i) the current exposure (sometimes referred to as the replacement cost) of the contract; and (ii) an estimate of the potential future credit exposure of the contract.

b. The current exposure is determined by the mark-to-market value of the contract. If the mark-to-market value is positive, then the current exposure is equal to that mark-to-market value. If the mark-to-market value is zero or negative, then the current exposure is zero. Mark-to-market values are measured in dollars, regardless of the currency or currencies specified in the contract, and should reflect changes in underlying rates, prices, and indices, as well as counterparty credit quality.

c. The potential future credit exposure of a contract, including a contract with a negative mark-to-market value, is estimated by multiplying the notional principal amount of the contract by a credit-conversion factor. Banks should use, subject to examiner review, the effective rather than the apparent or stated notional amount in this calculation. The conversion factors are:

Conversion Factors
(in percent)

Remaining maturity	*Interest-rate*	*Exchange-rate and gold*	*Equity*	*Commodity, excluding precious metals*	*Precious metals, except gold*
One year or less	0.0	1.0	6.0	10.0	7.0
Over one to five years	0.5	5.0	8.0	12.0	7.0
Over five years	1.5	7.5	10.0	15.0	8.0

d. For a contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the market value of the contract is zero, the remaining maturity is equal to the time until the next reset date. For an interest-rate contract with a remaining maturity of more than one year that meets these criteria, the minimum conversion factor is 0.5 percent.

e. For a contract with multiple exchanges of principal, the conversion factor is multiplied by the number of remaining payments in the contract. A derivative contract not included in the definitions of interest-rate, exchange-rate, equity, or commodity contracts as set forth in section III.E.1. of this appendix A, is subject to the same conversion factors as a commodity, excluding precious metals.

f. No potential future exposure is calculated for a single-currency interest-rate swap in which payments are made based upon two floating-rate indices (a so-called floating/floating or basis swap); the credit exposure on such a contract is evaluated solely on the basis of the mark-to-market value.

g. The Board notes that the conversion factors set forth above, which are based on observed volatilities of the particular types of instruments, are subject to review and modification in light of changing volatilities or market conditions.

3. *Netting.*

a. For purposes of this appendix A, netting refers to the offsetting of positive and negative mark-to-market values when determining a current exposure to be used in the calculation of a credit-equivalent amount. Any legally enforceable form of bilateral netting (that is, netting with a single counterparty) of derivative contracts is recognized for purposes of calculating the credit-equivalent amount provided that—

i. the netting is accomplished under a written netting contract that creates a single legal obligation, covering all included individual contracts, with the effect that the bank would have a claim to receive, or obligation to pay, only the net amount of the sum of the positive and negative mark-to-market values on included individual contracts in the event that a counterparty, or a counterparty to whom the contract has been validly assigned, fails to perform due to any of the following events: default, insolvency, liquidation, or similar circumstances;

ii. the bank obtains a written and reasoned legal opinion(s) representing that in the event of a legal challenge—including one resulting from default, insolvency, liquidation, or similar circumstances—the relevant court and administrative authorities would find the bank's exposure to be the net amount under—

   1. the law of the jurisdiction in which the counterparty is chartered or the equivalent location in the case of noncorporate entities, and if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located;

   2. the law that governs the individual contracts covered by the netting contract; and

   3. the law that governs the netting contract;

iii. the bank establishes and maintains procedures to ensure that the legal characteristics of netting contracts are kept under review in the light of possible changes in relevant law; and

iv. the bank maintains in its files documentation adequate to support the netting of derivative contracts, including a copy of the bilateral netting contract and necessary legal opinions.

b. A contract containing a walkaway clause is not eligible for netting for purposes of calculating the credit-equivalent amount.[49]

c. A bank netting individual contracts for the purpose of calculating credit-equivalent amounts of derivative contracts, represents that it has met the requirements of this appendix A and all the appropriate documents are in the bank's files and available for inspection by the Federal Reserve. The Federal Reserve may determine that a bank's files are inadequate or that a netting contract, or any of its underlying individual contracts, may not be legally enforceable under any one of the bodies of law described in section III.E.3.a.ii. of this appendix A. If such a determination is made, the netting contract may be disqualified from recognition for risk-based capital purposes or underlying individual contracts may be treated as though they are not subject to the netting contract.

d. The credit-equivalent amount of contracts that are subject to a qualifying bilateral netting contract is calculated by adding (i) the current exposure of the netting contract (net current exposure) and (ii) the sum of the estimates of potential future credit exposures on all individual contracts subject to the netting contract (gross potential future exposure) adjusted to reflect the effects of the netting contract.[50]

e. The net current exposure is the sum of all positive and negative mark-to-market values of the individual contracts included in the netting contract. If the net sum of the mark-to-market values is positive, then the net current exposure is equal to that sum. If the net sum of the mark-to-market values is zero or negative, then the net exposure is zero. The Federal Reserve may determine that a netting contract qualifies for risk-based capital netting treatment even though certain individual contracts included under the netting contract may not qualify. In such instances, the nonqualifying contracts

49 A walkaway clause is a provision in a netting contract that permits a nondefaulting counterparty to make lower payments than it would make otherwise under the contract, or no payment at all, to a defaulter or to the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the contract.

50 For purposes of calculating potential future credit exposure to a netting counterparty for foreign-exchange contracts and other similar contracts in which notional principal is equivalent to cash flows, total notional principal is defined as the net receipts falling due on each value date in each currency.

should be treated as individual contracts that are not subject to the netting contract.

f. Gross potential future exposure, or A_{gross} is calculated by summing the estimates of potential future exposure (determined in accordance with section III.E.2 of this appendix A) for each individual contract subject to the qualifying bilateral netting contract.

g. The effects of the bilateral netting contract on the gross potential future exposure are recognized through the application of a formula that results in an adjusted add-on amount (A_{net}). The formula, which employs the ratio of net current exposure to gross current exposure (NGR) is expressed as:

$$A_{net} = (0.4 \times A_{gross}) + 0.6(NGR \times A_{gross})$$

h. The NGR may be calculated in accordance with either the counterparty-by-counterparty approach or the aggregate approach.

i. Under the counterparty-by-counterparty approach, the NGR is the ratio of the net current exposure for a netting contract to the gross current exposure of the netting contract. The gross current exposure is the sum of the current exposures of all individual contracts subject to the netting contract calculated in accordance with section III.E.2. of this appendix A. Net negative mark-to-market values for individual netting contracts with the same counterparty may not be used to offset net positive mark-to-market values for other netting contracts with that counterparty.

ii. Under the aggregate approach, the NGR is the ratio of the sum of all of the net current exposures for qualifying bilateral netting contracts to the sum of all of the gross current exposures for those netting contracts (each gross current exposure is calculated in the same manner as in section III.E.3.h.i. of this appendix A). Net negative mark-to-market values for individual counterparties may not be used to offset net positive mark-to-market values for other counterparties.

iii. A bank must consistently use either the counterparty-by-counterparty approach or the aggregate approach to calculate the NGR. Regardless of the approach used, the NGR should be applied individually to each qualifying bilateral netting contract to determine the adjusted add-on for that netting contract.

i. In the event a netting contract covers contracts that are normally excluded from the risk-based ratio calculation—for example, exchange-rate contracts with an original maturity of 14 or fewer calendar days or instruments traded on exchanges that require daily payment and receipt of cash variation margin—a bank may elect to either include or exclude all mark-to-market values of such contracts when determining net current exposure, provided the method chosen is applied consistently.

4. *Risk weights.* Once the credit-equivalent amount for a derivative contract, or a group of derivative contracts subject to a qualifying bilateral netting contract, has been determined, that amount is assigned to the risk category appropriate to the counterparty, or, if relevant, the guarantor or the nature of any collateral.[51] However, the maximum risk weight applicable to the credit-equivalent amount of such contracts is 50 percent.

5. *Avoidance of double-counting.*

a. In certain cases, credit exposures arising from the derivative contracts covered by section III.E. of this appendix A may already be reflected, in part, on the balance sheet. To avoid double-counting such exposures in the assessment of capital adequacy and, perhaps, assigning inappropriate risk weights, counterparty credit exposures arising from the derivative instruments covered by these guidelines may need to be excluded from balance-sheet assets in calculating a bank's risk-based capital ratios.

b. Examples of the calculation of credit-equivalent amounts for contracts covered under this section III.E. are contained in attachment V of this appendix A.

[51] For derivative contracts, sufficiency of collateral or guarantees is generally determined by the market value of the collateral or the amount of the guarantee in relation to the credit-equivalent amount. Collateral and guarantees are subject to the same provisions noted under section III.B. of this appendix A.

IV. Minimum Supervisory Ratios and Standards

The interim and final supervisory standards set forth below specify *minimum* supervisory ratios based primarily on broad credit-risk considerations. As noted above, the risk-based ratio does not take explicit account of the quality of individual asset portfolios or the range of other types of risks to which banks may be exposed, such as interest-rate, liquidity, market, or operational risks. For this reason, banks are generally expected to operate with capital positions above the minimum ratios.

Institutions with high or inordinate levels of risk are expected to operate well above minimum capital standards. Banks experiencing or anticipating significant growth are also expected to maintain capital, including tangible capital positions, well above the minimum levels. For example, most such institutions generally have operated at capital levels ranging from 100 to 200 basis points above the stated minimums. Higher capital ratios could be required if warranted by the particular circumstances or risk profiles of individual banks. In all cases, banks should hold capital commensurate with the level and nature of all of the risks, including the volume and severity of problem loans, to which they are exposed.

Upon adoption of the risk-based framework, any bank that does not meet the interim or final supervisory ratios, or whose capital is otherwise considered inadequate, is expected to develop and implement a plan acceptable to the Federal Reserve for achieving an adequate level of capital consistent with the provisions of these guidelines or with the special circumstances affecting the individual institution. In addition, such banks should avoid any actions, including increased risk-taking or unwarranted expansion, that would lower or further erode their capital positions.

A. Minimum Risk-Based Ratio After Transition Period

As reflected in attachment VI, by year-end 1992, all state member banks should meet a minimum ratio of qualifying total capital to weighted-risk assets of 8 percent, of which at least 4.0 percentage points should be in the form of tier 1 capital. For purposes of section IV.A., tier 1 capital is defined as the sum of core capital elements less goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of this appendix. The maximum amount of supplementary capital elements that qualifies as tier 2 capital is limited to 100 percent of tier 1 capital. The maximum amount of supplementary capital elements that qualifies as tier 2 capital is limited to 100 percent of tier 1 capital. In addition, the combined maximum amount of subordinated debt and intermediate-term preferred stock that qualifies as tier 2 capital is limited to 50 percent of tier 1 capital. The maximum amount of the allowance for loan and lease losses that qualifies as tier 2 capital is limited to 1.25 percent of gross weighted-risk assets. Allowances for loan and lease losses in excess of this limit may, of course, be maintained, but would not be included in a bank's total capital. The Federal Reserve will continue to require banks to maintain reserves at levels fully sufficient to cover losses inherent in their loan portfolios.

Qualifying total capital is calculated by adding tier 1 capital and tier 2 capital (limited to 100 percent of tier 1 capital) and then deducting from this sum certain investments in banking or finance subsidiaries that are not consolidated for accounting or supervisory purposes, reciprocal holdings of banking organization capital securities, or other items at the direction of the Federal Reserve. These de-ductions are discussed above in section II(B).

B. Transition Arrangements

The transition period for implementing the risk-based capital standard ends on December 31, 1992.[52] Initially, the risk-based capital

[52] The Basle capital framework does not establish an initial minimum standard for the risk-based capital ratio before the end of 1990. However, for the purpose of calculating a risk-based capital ratio prior to year-end 1990, no sublimit is placed on the amount of the allowance for loan and lease losses includable in tier 2. In addition, this framework permits, under temporary transition arrangements, a certain percentage of a bank's tier 1 capital to be made up of supplementary capital elements. In particular, supplementary elements may constitute 25 percent of a bank's tier 1 capital (before the deduction of goodwill) up to the end of 1990; from year-end 1990 up to the end of 1992, this

Continued

guidelines do not establish a minimum level of capital. However, by year-end 1990, banks are expected to meet a minimum interim target ratio for qualifying total capital to weighted risk assets of 7.25 percent, at least one-half of which should be in the form of tier 1 capital. For purposes of meeting the 1990 interim target, the amount of loan-loss reserves that may be included in capital is limited to 1.5 percent of weighted-risk assets and up to 10 percent of a bank's tier 1 capital may consist of supplementary capital elements. Thus, the 7.25 percent interim target ratio implies a minimum ratio of tier 1 capital to weighted-risk assets of 3.6 percent (one-half of 7.25) and a minimum ratio of core capital elements to weighted-risk assets ratio of 3.25 percent (nine-tenths of the tier 1 capital ratio).

Through year-end 1990, banks have the option of complying with the minimum 7.25 percent year-end 1990 risk-based capital standard, in lieu of the minimum 5.5 percent primary and 6 percent total capital to total assets capital ratios set forth in appendix B to part 225 of the Federal Reserve's Regulation Y. In addition, as more fully set forth in appendix B to this part, banks are expected to maintain a minimum ratio of tier 1 capital to total assets during this transition period.

Continued
allowable percentage of supplementary elements in tier 1 declines to 10 percent of tier 1 (before the deduction of goodwill). Beginning on December 31, 1992, supplementary elements may not be included in tier 1. The amount of subordinated debt and intermediate-term preferred stock temporarily included in tier 1 under these arrangements will not be subject to the sublimit on the amount of such instruments includable in tier 2 capital. Goodwill must be deducted from the sum of a bank's permanent core capital elements (that is, common equity, noncumulative perpetual preferred stock, and minority interest in the equity of unconsolidated subsidiaries) plus supplementary items that may temporarily qualify as tier 1 elements for the purpose of calculating tier 1 (net of goodwill), tier 2, and total capital.

Attachment I—Sample Calculation of Risk-Based Capital Ratio for State Member Banks

Example of a bank with $6,000 in total capital and the following assets and off-balance-sheet items.

Balance-sheet assets

Cash	$ 5,000
U.S. Treasuries	20,000
Balances at domestic banks	5,000
Loans secured by first liens on 1- to 4-family residential properties	5,000
Loans to private corporations	65,000
Total Balance-Sheet Assets	$100,000

Off-balance-sheet items

Standby letters of credit (SLCs) backing general-obligation debt issues of U.S. municipalities (GOs)	$ 10,000
Long-term legally binding commitments to private corporations	20,000
Total Off-Balance-Sheet Items	$ 30,000

This bank's total capital to total assets (leverage) ratio would be:

($6,000/$100,000) = 6.00%.

To compute the bank's weighted-risk assets—

1. Compute the credit-equivalent amount of each off-balance-sheet (OBS) item.

OBS item	*Face value*		*Conversion factor*		*Credit-equivalent amount*
SLCs backing municipal GOs	$10,000	×	1.00	=	$10,000
Long-term commitments to private corporations	$20,000	×	0.50	=	$10,000

2. Multiply each balance-sheet asset and the credit-equivalent amount of each OBS item by the appropriate risk weight.

OBS item	*Face value*		*Conversion factor*		*Credit-equivalent amount*
0% category					
Cash	$ 5,000				
U.S. Treasuries	20,000				
	$25,000	×	0	=	0
20% category					
Balances at domestic banks	$ 5,000				
Credit-equivalent amounts of SLCs backing GOs of U.S. municipalities	10,000				
	$15,000	×	0.20	=	$ 3,000

OBS item	*Face value*		*Conversion factor*		*Credit-equivalent amount*
50% category					
Loans secured by first liens on 1- to 4-family residential properties	$ 5,000	×	0.50	=	$ 2,500
100% category					
Loans to private corporations	$65,000				
Credit-equivalent amounts of long-term commitments to private corporations	10,000				
	$75,000	×	1.00	=	$75,000
Total Risk-Weighted Assets					$80,500

This bank's ratio of total capital to weighted-risk assets (risk-based capital ratio) would be:

($6,000/$80,500) = 7.45%

Attachment II—Summary Definition of Qualifying Capital for State Member Banks*

Using the Year-End 1992 Standards

Components	*Minimum requirements after transition period*
CORE CAPITAL (tier 1)	Must equal or exceed 4% of weighted-risk assets
Common stockholders' equity	No limit
Qualifying noncumulative perpetual preferred stock	No limit; banks should avoid undue reliance on preferred stock in tier 1
Minority interest in equity accounts of consolidated subsidiaries	Banks should avoid using minority interests to introduce elements not otherwise qualifying for tier 1 capital
Less: Goodwill and other intangible assets required to be deducted from capital[1]	
SUPPLEMENTARY CAPITAL (tier 2)	Total of tier 2 is limited to 100% of tier 1[2]
Allowance for loan and lease losses	Limited to 1.25% of weighted-risk assets[2]
Perpetual preferred stock	No limit within tier 2
Hybrid capital instruments and equity-contract notes	No limit within tier 2
Subordinated debt and intermediate-term preferred stock (original weighted average maturity of 5 years or more)	Subordinated debt and intermediate-term preferred stock are limited to 50% of tier 1;[3] amortized for capital purposes as they approach maturity
Revaluation reserves (equity and building)	Not included; banks encouraged to disclose; may be evaluated on a case-by-case basis for international comparisons; and taken into account in making an overall assessment of capital
DEDUCTIONS (from sum of tier 1 and tier 2)	On a case-by-case basis or as a matter of policy after formal rulemaking
Investments in unconsolidated subsidiaries	
Reciprocal holdings of banking organizations' capital securities	
Other deductions (such as other subsidiaries or joint ventures) as determined by supervisory authority	
TOTAL CAPITAL (tier 1 + tier 2 − Deductions)	Must equal or exceed 8% of weighted-risk assets

1 Requirements for the deduction of other intangible assets are set forth in section II.B.1.b. of this appendix.
2 Amounts in excess of limitations are permitted but do not qualify as capital.
3 Amounts in excess of limitations are permitted but do not qualify as capital.

* See discussion in section II of the guidelines for a complete description of the requirements for, and the limitations on, the components of qualifying capital.

Attachment III—Summary of Risk Weights and Risk Categories for State Member Banks

Category 1: Zero Percent

1. Cash (domestic and foreign) held in the bank or in transit

2. Balances due from Federal Reserve Banks (including Federal Reserve Bank stock) and central banks in other OECD countries

3. Direct claims on, and the portions of claims that are unconditionally guaranteed by, the U.S. Treasury and U.S. government agencies[1] and the central governments of other OECD countries, and local currency claims on, and the portions of local currency claims that are unconditionally guaranteed by, the central governments of non-OECD countries (including the central banks of non-OECD countries), to the extent that the bank has liabilities booked in that currency

4. Gold bullion held in the bank's vaults or in another's vaults on an allocated basis, to the extent offset by gold bullion liabilities

5. Claims collateralized by cash on deposit in the bank or by securities issued or guaranteed by OECD central governments or U.S. government agencies for which a positive margin of collateral is maintained on a daily basis, fully taking into account any change in the bank's exposure to the obligor or counterparty under a claim in relation to the market value of the collateral held in support of that claim

Category 2: 20 Percent

1. Cash items in the process of collection

2. All claims (long- or short-term) on, and the portions of claims (long- or short-term) that are guaranteed by, U.S. depository institutions and OECD banks

3. Short-term claims (remaining maturity of one year or less) on, and the portions of short-term claims that are guaranteed by, non-OECD banks

4. The portions of claims that are conditionally guaranteed by the central governments of OECD countries and U.S. government agencies, and the portions of local currency claims that are conditionally guaranteed by the central governments of non-OECD countries, to the extent that the bank has liabilities booked in that currency

5. Claims on, and the portions of claims that are guaranteed by, U.S. government–sponsored agencies[2]

6. General obligation claims on, and the portions of claims that are guaranteed by the full faith and credit of, local governments and political subdivisions of the U.S. and other OECD local governments

7. Claims on, and the portions of claims that are guaranteed by, official multilateral lending institutions or regional development banks

8. The portions of claims that are collateralized[3] by cash on deposit in the bank or by securities issued or guaranteed by the U.S. Treasury, the central governments of other OECD countries, and U.S. government agencies that do not qualify for the zero percent risk-weight category, or that are collateralized by securities issued or guaranteed by U.S. government–sponsored agencies

9. The portions of claims that are collateralized[3] by securities issued by official multilateral lending institutions or regional development banks

10. Certain privately issued securities representing indirect ownership of mortgage-backed U.S. government agency or U.S. government–sponsored agency securities

11. Investments in shares of a fund whose portfolio is permitted to hold only securities

[1] For the purpose of calculating the risk-based capital ratio, a U.S. government agency is defined as an instrumentality of the U.S. government whose obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. government.

[2] For the purpose of calculating the risk-based capital ratio, a U.S. government–sponsored agency is defined as an agency originally established or chartered to serve public purposes specified by the U.S. Congress but whose obligations are not *explicitly* guaranteed by the full faith and credit of the U.S. government.

[3] The extent of collateralization is determined by current market value.

that would qualify for the zero or 20 percent risk categories

Category 3: 50 Percent

1. Loans fully secured by first liens on one- to four-family residential properties or on multifamily residential properties that have been made in accordance with prudent underwriting standards, that are performing in accordance with their original terms, that are not past due or in nonaccrual status, and that meet other qualifying criteria, and certain privately issued mortgage-backed securities representing indirect ownership of such loans. (Loans made for speculative purposes are excluded.)

2. Revenue bonds or similar claims that are obligations of U.S. state or local governments, or other OECD local governments, but for which the government entity is committed to repay the debt only out of revenues from the facilities financed

3. Credit-equivalent amounts of interest rate– and foreign exchange rate–related contracts, except for those assigned to a lower risk category

Category 4: 100 Percent

1. All other claims on private obligors

2. Claims on, or guaranteed by, non-OECD foreign banks with a remaining maturity exceeding one year

3. Claims on, or guaranteed by, non-OECD central governments that are not included in item 3 of category 1 or item 4 of category 2; all claims on non-OECD state or local governments

4. Obligations issued by U.S. state or local governments, or other OECD local governments (including industrial-development authorities and similar entities), repayable solely by a private party or enterprise

5. Premises, plant, and equipment; other fixed assets; and other real estate owned

6. Investments in any unconsolidated subsidiaries, joint ventures, or associated companies—if not deducted from capital

7. Instruments issued by other banking organizations that qualify as capital—if not deducted from capital

8. Claims on commercial firms owned by a government

9. All other assets, including any intangible assets that are not deducted from capital

Attachment IV—Credit-Conversion Factors for Off-Balance-Sheet Items for State Member Banks

100 Percent Conversion Factor

1. Direct credit substitutes (These include general guarantees of indebtedness and all guarantee-type instruments, including standby letters of credit backing the financial obligations of other parties.)

2. Risk participations in banker's acceptances and direct credit substitutes, such as standby letters of credit

3. Sale and repurchase agreements and assets sold with recourse that are not included on the balance sheet

4. Forward agreements to purchase assets, including financing facilities, on which draw-down is certain

5. Securities lent for which the bank is at risk

50 Percent Conversion Factor

1. Transaction-related contingencies (These include bid bonds, performance bonds, warranties, and standby letters of credit backing the nonfinancial performance of other parties.)

2. Unused portions of commitments with an original maturity exceeding one year, including underwriting commitments and commercial credit lines

3. Revolving underwriting facilities (RUFs), note-issuance facilities (NIFs), and similar arrangements

20 Percent Conversion Factor

Short-term, self-liquidating, trade-related contingencies, including commercial letters of credit

Zero Percent Conversion Factor

Unused portions of commitments with an original maturity of one year or less, or which are unconditionally cancellable at any time, provided a separate credit decision is made before each drawing

Credit Conversion for Derivative Contracts

1. The credit-equivalent amount of a derivative contract is the sum of the current credit exposure of the contract and an estimate of potential future increases in credit exposure. The current exposure is the positive mark-to-market value of the contract (or zero if the mark-to-market value is zero or negative). For derivative contracts that are subject to a qualifying bilateral netting contract, the current exposure is, generally, the net sum of the positive and negative mark-to-market values of the contracts included in the netting contract (or zero if the net sum of the mark-to-market values is zero or negative). The potential future exposure is calculated by multiplying the effective notional amount of a contract by one of the following credit-conversion factors, as appropriate:

Conversion Factors
(in percent)

Remaining Maturity	*Interest-rate*	*Exchange-rate and gold*	*Equity*	*Commodity, excluding precious metals*	*Precious metals, except gold*
One year or less	0.0	1.0	6.0	10.0	7.0
Over one to five years	0.5	5.0	8.0	12.0	7.0
Over five years	1.5	7.5	10.0	15.0	8.0

For contracts subject to a qualifying bilateral netting contract, the potential future exposure is, generally, the sum of the individual potential future exposures for each contract included under the netting contract adjusted by the application of the following formula:

$$A_{net} = (0.4 \times A_{gross}) + 0.6(NGR \times A_{gross})$$

NGR is the ratio of net current exposure to gross current exposure.

2. No potential future exposure is calculated for single-currency interest-rate swaps in which payments are made based upon two floating indices, that is, so-called floating/floating or basis swaps. The credit exposure on these contracts is evaluated solely on the basis of their mark-to-market value. Exchange-rate contracts with an original maturity of 14 days or fewer are excluded. Instruments traded on exchanges that require daily receipt and payment of cash variation margin are also excluded.

Attachment V—Calculating Credit-Equivalent Amounts for Derivative Contracts

Type of contract	*Notional principal amount*	*Conversion factor*	*Potential exposure (dollars)*	*Mark-to-market*	*Current exposure (dollars)*	*Credit-equivalent amount*
(1) 120-day forward foreign exchange	5,000,000	.01	50,000	100,000	100,000	150,000
(2) 4-year forward foreign exchange	6,000,000	.05	300,000	−120,000	–0–	300,000
(3) 3-year single-currency fixed and floating interest-rate swap	10,000,000	.005	50,000	200,000	200,000	250,000
(4) 6-month oil swap	10,000,000	.10	1,000,000	−250,000	–0–	1,000,000
(5) 7-year cross-currency floating and floating interest-rate swap	20,000,000	.075	1,500,000	−1,500,000	–0–	1,500,000
TOTAL			2,900,000	+	300,000	$3,200,000

a. If contracts (1) through (5) above are subject to a qualifying bilateral netting contract, then the following applies:

Contract	*Potential future exposure*		*Net current exposure*		*Credit-equivalent amount*
(1)	50,000				
(2)	300,000				
(3)	50,000				
(4)	1,000,000				
(5)	1,500,000				
TOTAL	2,900,000	+	0	=	2,900,000

NOTE: The total of the mark-to-market values from the first table is −1,370,000. Since this is a negative amount, the net current exposure is zero.

b. To recognize the effects of bilateral netting on potential future exposure the following formula applies:

$$A_{net} = (.4 \times A_{gross}) + .6(NGR \times A_{gross})$$

c. In the above example where the net current exposure is zero, the credit-equivalent amount would be calculated as follows:

$$NGR = 0 = (0/300{,}000)$$

$$A_{net} = (0.4 \times \$2{,}900{,}000) + 0.6(0 \times \$2{,}900{,}000)$$

$$A_{net} = \$1{,}160{,}000$$

The credit-equivalent amount is $1,160,000 + 0 = $1,160,000.

d. If the net current exposure was a positive number, for example $200,000, the credit-equivalent amount would be calculated as follows:

$$NGR = .67 = (\$200{,}000/\$300{,}000)$$

$$A_{net} = (0.4 \times \$2{,}900{,}000) + 0.6(.67 \times \$2{,}900{,}000)$$

$$A_{net} = \$2{,}325{,}800$$

The credit-equivalent amount would be $2,325,800 + $200,000 = $2,525,800.

Attachment VI

SUMMARY OF:

	Transitional Arrangements for State Member Banks		*Final Arrangement*
	Initial	*Year-end 1990*	*Year-end 1992*
1. Minimum standard of total capital to weighted-risk assets	None	7.25%	8.0%
2. Definition of tier 1 capital	Common equity, qualifying noncumulative perpetual preferred stock, minority interests, *plus* supplementary elements[1] *less* goodwill	Common equity, qualifying noncumulative perpetual preferred stock, minority interests, *plus* supplementary elements[2] *less* goodwill	Common equity, qualifying noncumulative perpetual preferred stock, and minority interest *less* goodwill and other intangible assets required to be deducted from capital[3]
3. Minimum standard of tier 1 capital to weighted-risk assets	None	3.625%	4.0%
4. Minimum standard of stockholders' equity to weighted-risk assets	None	3.25%	4.0%
5. Limitations on supplementary capital elements			
a. Allowance for loan and lease losses	No limit within tier 2	1.5% of weighted-risk assets	1.25% of weighted-risk assets
b. Qualifying perpetual preferred stock	No limit within tier 2	No limit within tier 2	No limit within tier 2
c. Hybrid capital instruments and equity contract notes	No limit within tier 2	No limit within tier 2	No limit within tier 2
d. Subordinated debt and intermediate-term preferred stock	Combined maximum of 50% of tier 1	Combined maximum of 50% of tier 1	Combined maximum of 50% of tier 1
e. Total qualifying tier 2 capital	May not exceed tier 1 capital	May not exceed tier 1 capital	May not exceed tier 1 capital
6. Definition of total capital	Tier 1 *plus* tier 2 *less*: • reciprocal holdings of banking organizations' capital instruments • investments in unconsolidated subsidiaries	Tier 1 *plus* tier 2 *less*: • reciprocal holdings of banking organizations' capital instruments • investments in unconsolidated subsidiaries	Tier 1 *plus* tier 2 *less*: • reciprocal holdings of banking organizations' capital instruments • investments in unconsolidated subsidiaries

[1] Supplementary elements may be included in tier 1 up to 25% of the sum of tier 1 plus goodwill.
[2] Supplementary elements may be included in tier 1 up to 10% of the sum of tier 1 plus goodwill.
[3] Requirements for the deduction of other intangible assets are set forth in section II.B.1.b of this appendix.

Capital Adequacy Guidelines for Bank Holding Companies: Risk-Based Measure

12 CFR 225, appendix A; as amended effective October 1, 1995

I. Overview

The Board of Governors of the Federal Reserve System has adopted a risk-based capital measure to assist in the assessment of the capital adequacy of bank holding companies ("banking organizations").[1] The principal objectives of this measure are to (i) make regulatory capital requirements more sensitive to differences in risk profiles among banking organizations; (ii) factor off-balance-sheet exposures into the assessment of capital adequacy; (iii) minimize disincentives to holding liquid, low-risk assets; and (iv) achieve greater consistency in the evaluation of the capital adequacy of major banking organizations throughout the world.[2]

In addition, when certain organizations that engage in trading activities calculate their risk-based capital ratio under this appendix A, they must also refer to appendix E of this part, which incorporates capital charges for certain market risks into the risk-based capital ratio. When calculating their risk-based capital ratio under this appendix A, such organizations are required to refer to appendix E of this part for supplemental rules to determine qualifying and excess capital, calculate risk-weighted assets, calculate market-risk-equivalent assets, and calculate risk-based capital ratios adjusted for market risk.

The risk-based capital guidelines include both a definition of capital and a framework for calculating weighted-risk assets by assigning assets and off-balance-sheet items to broad risk categories. An institution's risk-based capital ratio is calculated by dividing its qualifying capital (the numerator of the ratio) by its weighted-risk assets (the denominator).[3] The definition of "qualifying capital" is outlined below in section II, and the procedures for calculating weighted-risk assets are discussed in section III. Attachment I illustrates a sample calculation of weighted-risk assets and the risk-based capital ratio.

The risk-based capital guidelines also establish a schedule for achieving a minimum supervisory standard for the ratio of qualifying capital to weighted-risk assets and provide for transitional arrangements during a phase-in period to facilitate adoption and implementation of the measure at the end of 1992. These interim standards and transitional arrangements are set forth in section IV.

The risk-based guidelines apply on a consolidated basis to bank holding companies with consolidated assets of $150 million or more. For bank holding companies with less than $150 million in consolidated assets, the guidelines will be applied on a bank-only basis unless (a) the parent bank holding company is engaged in nonbank activity involving significant leverage;[4] or (b) the parent company has a significant amount of outstanding debt that is held by the general public.

The risk-based guidelines are to be used in the inspection and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. Thus, in considering an application filed by a bank holding company, the Federal Reserve will take into account the organization's risk-based capital ratio, the reasonableness of its capital plans, and the degree of progress it has demonstrated toward meeting the interim and final risk-based capital standards.

The risk-based capital ratio focuses princi-

[1] Supervisory ratios that relate capital to total assets for bank holding companies are outlined in appendixes B and D of this part.

[2] The risk-based capital measure is based upon a framework developed jointly by supervisory authorities from the countries represented on the Basle Committee on Banking Regulations and Supervisory Practices (Basle Supervisors' Committee) and endorsed by the Group of Ten Central Bank Governors. The framework is described in a paper prepared by the BSC entitled "International Convergence of Capital Measurement," July 1988.

[3] Banking organizations will initially be expected to utilize period-end amounts in calculating their risk-based capital ratios. When necessary and appropriate, ratios based on average balances may also be calculated on a case-by-case basis. Moreover, to the extent banking organizations have data on average balances that can be used to calculate risk-based ratios, the Federal Reserve will take such data into account.

[4] A parent company that is engaged in significant off-balance-sheet activities would generally be deemed to be engaged in activities that involve significant leverage.

pally 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 risk-based ratio does not, however, incorporate other factors that can affect an organization's financial condition. These factors include overall interest-rate exposure; liquidity, funding, and market risks; the quality and level of earnings; investment or loan portfolio concentrations; the quality of loans and investments; the effectiveness of loan and investment policies; and management's ability to monitor and control financial and operating risks.

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

The risk-based capital guidelines establish *minimum* ratios of capital to weighted-risk assets. In light of the considerations just discussed, banking organizations generally are expected to operate well above the minimum risk-based ratios. In particular, banking organizations contemplating significant expansion proposals are expected to maintain strong capital levels substantially above the minimum ratios and should not allow significant diminution of financial strength below these strong levels to fund their expansion plans. Institutions with high or inordinate levels of risk are also expected to operate above minimum capital standards. In all cases, institutions should hold capital commensurate with the level and nature of the risks to which they are exposed. Banking organizations that do not meet the minimum risk-based standard, or that are otherwise considered to be inadequately capitalized, are expected to develop and implement plans acceptable to the Federal Reserve for achieving adequate levels of capital within a reasonable period of time.

The Board will monitor the implementation and effect of these guidelines in relation to domestic and international developments in the banking industry. When necessary and appropriate, the Board will consider the need to modify the guidelines in light of any significant changes in the economy, financial markets, banking practices, or other relevant factors.

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

An institution's qualifying total capital consists of two types of capital components: "core capital elements" (comprising tier 1 capital) and "supplementary capital elements" (comprising tier 2 capital). These capital elements and the various limits, restrictions, and deductions to which they are subject, are discussed below and are set forth in attachment II.

To qualify as an element of tier 1 or tier 2 capital, a capital instrument may not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices.

Redemptions of permanent equity or other capital instruments before stated maturity could have a significant impact on an organization's overall capital structure. Consequently, an organization considering such a step should consult with the Federal Reserve before redeeming any equity or debt capital instrument (prior to maturity) if such redemption could have a material effect on the level or composition of the organization's capital base.[5]

A. The Components of Qualifying Capital

1. *Core capital elements (tier 1 capital).* The tier 1 component of an institution's qualifying capital must represent at least 50 percent of qualifying total capital and may consist of the following items that are defined as core capital elements:

[5] Consultation would not ordinarily be necessary if an instrument were redeemed with the proceeds of, or replaced by, a like amount of a similar or higher-quality capital instrument and the organization's capital position is considered fully adequate by the Federal Reserve. In the case of limited-life tier 2 instruments, consultation would generally be obviated if the new security is of equal or greater maturity than the one it replaces.

i. common stockholders' equity
ii. qualifying noncumulative perpetual preferred stock (including related surplus)
iii. qualifying cumulative perpetual preferred stock (including related surplus), subject to certain limitations described below
iv. minority interest in the equity accounts of consolidated subsidiaries

Tier 1 capital is generally defined as the sum of the core capital elements[6] less goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of this appendix.

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

b. *Perpetual preferred stock.* Perpetual preferred stock is defined as preferred stock that does not have a maturity date, that cannot be redeemed at the option of the holder of the instrument, and that has no other provisions that will require future redemption of the issue. Consistent with these provisions, any perpetual preferred stock with a feature permitting redemption at the option of the issuer may qualify as capital *only if* the redemption is subject to prior approval of the Federal Reserve. In general, preferred stock will qualify for inclusion in capital only if it can absorb losses while the issuer operates as a going concern (a fundamental characteristic of equity capital) *and* only if the issuer has the ability and legal right to defer or eliminate preferred dividends.

Perpetual preferred stock in which the dividend is reset periodically based, in whole or in part, upon the banking organization's current credit standing (that is, auction rate perpetual preferred stock, including so-called Dutch auction, money market, and remarketable preferred) will not qualify for inclusion in tier 1 capital.[7] Such instruments, however, qualify for inclusion in tier 2 capital.

For bank holding companies, both cumulative and noncumulative perpetual preferred stock qualify for inclusion in tier 1. However, the aggregate amount of cumulative perpetual preferred stock that may be included in a holding company's tier 1 is limited to one-third of the sum of core capital elements, excluding the perpetual preferred stock (that is, items i, ii, and iv above). Stated differently, the aggregate amount may not exceed 25 percent of the sum of all core capital elements, including cumulative perpetual preferred stock (that is, items i, ii, iii and iv above). Any cumulative perpetual preferred stock outstanding in excess of this limit may be included in tier 2 capital without any sublimits within that tier (see discussion below).

While the guidelines allow for the inclusion of noncumulative perpetual preferred stock and limited amounts of cumulative perpetual preferred stock in tier 1, it is desirable from a supervisory standpoint that voting common equity remain the dominant form of tier 1 capital. Thus, bank holding companies should avoid overreliance on preferred stock or nonvoting equity elements within tier 1.

c. *Minority interest in equity accounts of consolidated subsidiaries.* This element is included in tier 1 because, as a general rule, it represents equity that is freely available to absorb losses in operating subsidiaries. While not subject to an explicit sublimit within tier 1, banking organizations are expected to avoid using minority interest in the equity accounts of consolidated subsid-

[6] During the transition period and subject to certain limitations set forth in section IV below, tier 1 capital may also include items defined as supplementary capital elements.

[7] Adjustable-rate perpetual preferred stock (that is, perpetual preferred stock in which the dividend rate is not affected by the issuer's credit standing or financial condition but is adjusted periodically according to a formula based solely on general market interest rates) may be included in tier 1 up to the limits specified for perpetual preferred stock.

iaries as an avenue for introducing into their capital structures elements that might not otherwise qualify as tier 1 capital or that would, in effect, result in an excessive reliance on preferred stock within tier 1.

2. *Supplementary capital elements (tier 2 capital).* The tier 2 component of an institution's qualifying total capital may consist of the following items that are defined as supplementary capital elements:

- i. Allowance for loan and lease losses (subject to limitations discussed below)
- ii. Perpetual preferred stock and related surplus (subject to conditions discussed below)
- iii. Hybrid capital instruments (as defined below), perpetual debt, and mandatory convertible debt securities
- iv. Term subordinated debt and intermediate-term preferred stock, including related surplus (subject to limitations discussed below)

The maximum amount of tier 2 capital that may be included in an organization's qualifying total capital is limited to 100 percent of tier 1 capital (net of goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of this appendix).

The elements of supplementary capital are discussed in greater detail below.[8]

a. *Allowance for loan and lease losses.* Allowances for loan and lease losses are reserves that have been established through a charge against earnings to absorb future losses on loans or lease-financing receivables. Allowances for loan and lease losses exclude "allocated transfer risk reserves,"[9] and reserves created against identified losses.

During the transition period, the risk-based capital guidelines provide for reducing the amount of this allowance that may be included in an institution's total capital. Initially, it is unlimited. However, by year-end 1990, the amount of the allowance for loan and lease losses that will qualify as capital will be limited to 1.5 percent of an institution's weighted-risk assets. By the end of the transition period, the amount of the allowance qualifying for inclusion in tier 2 capital may not exceed 1.25 percent of weighted-risk assets.[10]

b. *Perpetual preferred stock.* Perpetual preferred stock, as noted above, is defined as preferred stock that has no maturity date, that cannot be redeemed at the option of the holder, and that has no other provisions that will require future redemption of the issue. Such instruments are eligible for inclusion in tier 2 capital without limit.[11]

c. *Hybrid capital instruments, perpetual debt, and mandatory convertible debt securities.* Hybrid capital instruments include instruments that are essentially permanent in nature and that have certain characteristics of both equity and debt. Such instruments may be included in tier 2 without limit. The general criteria hybrid capital instruments

[8] The Basle capital framework also provides for the inclusion of "undisclosed reserves" in tier 2. As defined in the framework, undisclosed reserves represent accumulated after-tax retained earnings that are not disclosed on the balance sheet of a banking organization. Apart from the fact that these reserves are not disclosed publicly, they are essentially of the same quality and character as retained earnings, and, to be included in capital, such reserves must be accepted by the banking organization's home supervisor. Although such undisclosed reserves are common in some countries, under generally accepted accounting principles (GAAP) and long-standing supervisory practice, these types of reserves are not recognized for banking organizations in the United States. Foreign banking organizations seeking to make acquisitions or conduct business in the United States would generally be expected to disclose publicly at least the degree of reliance on such reserves in meeting supervisory capital requirements.

[9] Allocated transfer risk reserves are reserves that have been established in accordance with section 905(a) of the International Lending Supervision Act of 1983, 12 USC 3904(a), against certain assets whose value U.S. supervisory authorities have found to be significantly impaired by protracted transfer risk problems.

[10] The amount of the allowance for loan and lease losses that may be included in tier 2 capital is based on a percentage of gross weighted-risk assets. A banking organization may deduct reserves for loan and lease losses in excess of the amount permitted to be included in tier 2 capital, as well as allocated transfer risk reserves, from the sum of gross weighted-risk assets and use the resulting net sum of weighted-risk assets in computing the denominator of the risk-based capital ratio.

[11] Long-term preferred stock with an original maturity of 20 years or more (including related surplus) will also qualify in this category as an element of tier 2. If the holder of such an instrument has a right to require the issuer to redeem, repay, or repurchase the instrument prior to the original stated maturity, maturity would be defined, for risk-based capital purposes, as the earliest possible date on which the holder can put the instrument back to the issuing banking organization.

must meet in order to qualify for inclusion in tier 2 capital are listed below:

1. The instrument must be unsecured; fully paid up; and subordinated to general creditors. If issued by a bank, it must also be subordinated to claims of depositors.
2. The instrument must not be redeemable at the option of the holder prior to maturity, except with the prior approval of the Federal Reserve. (Consistent with the Board's criteria for perpetual debt and mandatory convertible securities, this requirement implies that holders of such instruments may not accelerate the payment of principal except in the event of bankruptcy, insolvency, or reorganization.)
3. The instrument must be available to participate in losses while the issuer is operating as a going concern. (Term subordinated debt would not meet this requirement.) To satisfy this requirement, the instrument must convert to common or perpetual preferred stock in the event that the accumulated losses exceed the sum of the retained earnings and capital surplus accounts of the issuer.
4. The instrument must provide the option for the issuer to defer interest payments if (a) the issuer does not report a profit in the preceding annual period (defined as combined profits for the most recent four quarters) *and* (b) the issuer eliminates cash dividends on common and preferred stock.

Perpetual debt and mandatory convertible debt securities that meet the criteria set forth in 12 CFR 225, appendix B, also qualify as unlimited elements of tier 2 capital for bank holding companies.

d. *Subordinated debt and intermediate-term preferred stock.* The aggregate amount of term subordinated debt (excluding mandatory convertible debt) and intermediate-term preferred stock that may be treated as supplementary capital is limited to 50 percent of tier 1 capital (net of goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of this appendix). Amounts in excess of these limits may be issued and, while not included in the ratio calculation, will be taken into account in the overall assessment of an organization's funding and financial condition.

Subordinated debt and intermediate-term preferred stock must have an original weighted average maturity of at least five years to qualify as supplementary capital.[12] (If the holder has the option to require the issuer to redeem, repay, or repurchase the instrument prior to the original stated maturity, maturity would be defined, for risk-based capital purposes, as the earliest possible date on which the holder can put the instrument back to the issuing banking organization.)

In the case of subordinated debt, the instrument must be unsecured and must clearly state on its face that it is not a deposit and is not insured by a federal agency. Bank holding company debt must be subordinated in right of payment to all senior indebtedness of the company.

e. *Discount of supplementary capital instruments.* As a limited-life capital instrument approaches maturity it begins to take on characteristics of a short-term obligation. For this reason, the outstanding amount of term subordinated debt and any long- or intermediate-life, or term, preferred stock eligible for inclusion in tier 2 is reduced, or discounted, as these instruments approach maturity: one-fifth of the original amount, less any redemptions, is excluded each year during the instrument's last five years before maturity.[13]

[12] Unsecured term debt issued by bank holding companies prior to March 12, 1988, and qualifying as secondary capital at the time of issuance would continue to qualify as an element of supplementary capital under the risk-based framework, subject to the 50 percent of tier 1 capital limitation. Bank holding company term debt issued on or after March 12, 1988, must be subordinated in order to qualify as capital.

[13] For example, outstanding amounts of these instruments that count as supplementary capital include 100 percent of the outstanding amounts with remaining maturities of more than five years; 80 percent of outstanding amounts with remaining maturities of four to five years; 60 percent of outstanding amounts with remaining maturities of three to four years; 40 percent of outstanding amounts with remaining maturities of two to three years; 20 percent of outstanding amounts with remaining maturities of one to two years; and 0 percent of outstanding amounts with remaining

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f. *Revaluation reserves.*

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

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

B. Deductions from Capital and Other Adjustments

Certain assets are deducted from an organization's capital for the purpose of calculating the risk-based capital ratio.[14] These assets include—

i. a. Goodwill—deducted from the sum of core capital elements

b. Certain identifiable intangible assets, that is, intangible assets other than goodwill—deducted from the sum of core capital elements in accordance with section II.B.1.b. of this appendix.

ii. investments in banking and finance subsidiaries that are not consolidated for accounting or supervisory purposes, and investments in other designated subsidiaries or associated companies at the discretion of the Federal Reserve—deducted from total capital components (as described in greater detail below)

iii. reciprocal holdings of capital instruments of banking organizations—deducted from total capital components

iv. Deferred tax assets—portions are deducted from the sum of core capital elements in accordance with section II.B.4. of this appendix A.

1. *Goodwill and other intangible assets.*

a. *Goodwill.* Goodwill is an intangible asset that represents the excess of the purchase price over the fair market value of identifiable assets acquired less liabilities assumed in acquisitions accounted for under the purchase method of accounting. Any goodwill carried on the balance sheet of a bank holding company after December 31, 1992, will be deducted from the sum of core capital elements in determining tier 1 capital for ratio-calculation purposes. Any goodwill in existence before March 12, 1988, is grandfathered during the transition period and is not deducted from core capital elements until after December 31, 1992. However, bank holding company goodwill acquired as a result of a merger or acquisition that was consummated on or after March 12, 1988, is deducted immediately.

b. i. *Other 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 rights and purchased credit-card relationships, provided that, in the aggregate, the total amount of these assets included in capital does not exceed 50 percent of tier 1 capital. Purchased credit-card relationships are subject to a separate sublimit of 25 percent of tier 1 capital.[15]

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maturities of less than one year. Such instruments with a remaining maturity of less than one year are excluded from tier 2 capital.

[14] Any assets deducted from capital in computing the numerator of the ratio are not included in weighted-risk assets in computing the denominator of the ratio.

[15] Amounts of mortgage-servicing rights and purchased credit-card relationships in excess of these limitations, as well as all other identifiable intangible assets, including core deposit intangibles and favorable leaseholds, are to be deducted from an organization's core capital elements in determining tier 1 capital. However, identifiable intangible assets (other than mortgage-servicing rights 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.

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

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 market value of mortgage-servicing rights and purchased credit-card relationships also must be determined at least quarterly. The fair market value generally shall be determined by applying an appropriate market discount rate to the expected future net cash flows. 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 market 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.

v. The amount of mortgage-servicing rights and purchased credit-card relationships that a bank holding company may include in capital shall be the *lesser* of 90 percent of their fair market 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 rights and purchased credit-card relationships and the adjustment of the balance-sheet amount for these intangibles would result in an amount being deducted from capital, the bank holding company would deduct only the greater of the two amounts from its core capital elements in determining tier 1 capital.

vi. The treatment of identifiable intangible assets set forth in this section generally will be used in the calculation of a bank holding company's capital ratios for supervisory and applications purposes. However, in making an overall assessment of an organization's capital adequacy for applications purposes, the Board may, if it deems appropriate, take into account the quality and composition of an organization's capital, together with the quality and value of its tangible and intangible assets.

vii. Consistent with long-standing Board policy, banking organizations experiencing substantial growth, whether internally or by acquisition, are expected to maintain strong capital positions substantially above minimum supervisory levels, without significant reliance on intangible assets.

2. *Investments in certain subsidiaries.*

a. *Unconsolidated banking or finance subsidiaries.* The aggregate amount of investments in banking or finance subsidiaries[16] whose financial statements are not consolidated for accounting or regulatory-reporting purposes, regardless of whether the investment is made by the parent bank holding company or its direct or indirect subsidiaries, will be deducted from the consolidated parent banking organization's total capital components.[17] Generally, investments for this purpose are defined as equity and debt

[16] For this purpose, a banking and finance subsidiary generally is defined as any company engaged in banking or finance in which the parent institution holds directly or indirectly more than 50 percent of the outstanding voting stock, or which is otherwise controlled or capable of being controlled by the parent institution.

[17] An exception to this deduction would be made in the case of shares acquired in the regular course of securing or collecting a debt previously contracted in good faith. The requirements for consolidation are spelled out in the instructions to the FR Y-9C Report.

capital investments and any other instruments that are deemed to be capital in the particular subsidiary.

Advances (that is, loans, extensions of credit, guarantees, commitments, or any other forms of credit exposure) to the subsidiary that are not deemed to be capital will generally not be deducted from an organization's capital. Rather, such advances generally will be included in the parent banking organization's consolidated assets and be assigned to the 100 percent risk category, unless such obligations are backed by recognized collateral or guarantees, in which case they will be assigned to the risk category appropriate to such collateral or guarantees. These advances may, however, also be deducted from the consolidated parent banking organization's capital if, in the judgment of the Federal Reserve, the risks stemming from such advances are comparable to the risks associated with capital investments or if the advances involve other risk factors that warrant such an adjustment to capital for supervisory purposes. These other factors could include, for example, the absence of collateral support.

Inasmuch as the assets of unconsolidated banking and finance subsidiaries are not fully reflected in a banking organization's consolidated total assets, such assets may be viewed as the equivalent of off-balance-sheet exposures since the operations of an unconsolidated subsidiary could expose the parent organization and its affiliates to considerable risk. For this reason, it is generally appropriate to view the capital resources invested in these unconsolidated entities as primarily supporting the risks inherent in these off-balance-sheet assets, and not generally available to support risks or absorb losses elsewhere in the organization.

b. *Other subsidiaries and investments.* The deduction of investments, regardless of whether they are made by the parent bank holding company or by its direct or indirect subsidiaries, from a consolidated banking organization's capital will also be applied in the case of any subsidiaries, that, while consolidated for accounting purposes, are not consolidated for certain specified supervisory or regulatory purposes, such as to facilitate functional regulation. For this purpose, aggregate capital investments (that is, the sum of any equity or debt instruments that are deemed to be capital) in these subsidiaries will be deducted from the consolidated parent banking organization's total capital components.[18]

Advances (that is, loans, extensions of credit, guarantees, commitments, or any other forms of credit exposure) to such subsidiaries that are not deemed to be capital will generally not be deducted from capital. Rather, such advances will normally be included in the parent banking organization's consolidated assets and assigned to the 100 percent risk category, unless such obligations are backed by recognized collateral or guarantees, in which case they will be assigned to the risk category appropriate to such collateral or guarantees. These advances may, however, be deducted from the consolidated parent banking organization's capital if, in the judgment of the Federal Reserve, the risks stemming from such advances are comparable to the risks associated with capital investments or if such advances involve other risk factors that warrant such an adjustment to capital for supervisory purposes. These other factors could include, for example, the absence of collateral support.[19]

In general, when investments in a consolidated subsidiary are deducted from a consolidated parent banking organization's capital, the subsidiary's assets will also be excluded from the consolidated assets of the parent banking organization in order to assess the latter's capital adequacy.[20]

[18] Investments in unconsolidated subsidiaries will be deducted from both tier 1 and tier 2 capital. As a general rule, one-half (50 percent) of the aggregate amount of capital investments will be deducted from the bank holding company's tier 1 capital and one-half (50 percent) from its tier 2 capital. However, the Federal Reserve may, on a case-by-case basis, deduct a proportionately greater amount from tier 1 if the risks associated with the subsidiary so warrant. If the amount deductible from tier 2 capital exceeds actual tier 2 capital, the excess would be deducted from tier 1 capital. Bank holding companies' risk-based capital ratios, net of these deductions, must exceed the minimum standards set forth in section IV.

[19] In assessing the overall capital adequacy of a banking organization, the Federal Reserve may also consider the organization's fully consolidated capital position.

[20] If the subsidiary's assets are consolidated with the

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The Federal Reserve may also deduct from a banking organization's capital, on a case-by-case basis, investments in certain other subsidiaries in order to determine if the consolidated banking organization meets minimum supervisory capital requirements without reliance on the resources invested in such subsidiaries.

The Federal Reserve will not automatically deduct investments in other unconsolidated subsidiaries or investments in joint ventures and associated companies.[21] Nonetheless, the resources invested in these entities, like investments in unconsolidated banking and finance subsidiaries, support assets not consolidated with the rest of the banking organization's activities and, therefore, may not be generally available to support additional leverage or absorb losses elsewhere in the banking organization. Moreover, experience has shown that banking organizations stand behind the losses of affiliated institutions, such as joint ventures and associated companies, in order to protect the reputation of the organization as a whole. In some cases, this has led to losses that have exceeded the investments in such organizations.

For this reason, the Federal Reserve will monitor the level and nature of such investments for individual banking organizations and may, on a case-by-case basis, deduct such investments from total capital components, apply an appropriate risk-weighted capital charge against the organization's proportionate share of the assets of its associated companies, require a line-by-line consolidation of the entity (in the event that the parent's control over the entity makes it the functional equivalent of a subsidiary), or otherwise require the organization to operate with a risk-based capital ratio above the minimum.

In considering the appropriateness of such adjustments or actions, the Federal Reserve will generally take into account whether—

1. the parent banking organization has significant influence over the financial or managerial policies or operations of the subsidiary, joint venture, or associated company;
2. the banking organization is the largest investor in the affiliated company; or
3. other circumstances prevail that appear to closely tie the activities of the affiliated company to the parent banking organization.

3. *Reciprocal holdings of banking organizations' capital instruments.* Reciprocal holdings of banking organizations' capital instruments (that is, instruments that qualify as tier 1 or tier 2 capital) will be deducted from an organization's total capital components for the purpose of determining the numerator of the risk-based capital ratio.

Reciprocal holdings are cross-holdings resulting from formal or informal arrangements in which two or more banking organizations swap, exchange, or otherwise agree to hold each other's capital instruments. Generally, deductions will be limited to intentional cross-holdings. At present, the Board does not intend to require banking organizations to deduct nonreciprocal holdings of such capital instruments.[22]

4. *Deferred-tax assets.* The amount of deferred-tax assets that are 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

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parent banking organization for financial-reporting purposes, this adjustment will involve excluding the subsidiary's assets on a line-by-line basis from the consolidated parent organization's assets. The parent banking organization's capital ratio will then be calculated on a consolidated basis with the exception that the assets of the excluded subsidiary will not be consolidated with the remainder of the parent banking organization.

[21] The definition of such entities is contained in the instructions to the Consolidated Financial Statements for Bank Holding Companies. Under regulatory-reporting procedures, associated companies and joint ventures generally are defined as companies in which the banking organization owns 20 to 50 percent of the voting stock.

[22] Deductions of holdings of capital securities also would not be made in the case of interstate "stake out" investments that comply with the Board's policy statement on nonvoting equity investments, 12 CFR 225.143. In addition, holdings of capital instruments issued by other banking organizations but taken in satisfaction of debts previously contracted would be exempt from any deduction from capital. The Board intends to monitor nonreciprocal holdings of other banking organizations' capital instruments and to provide information on such holdings to the Basle Supervisors' Committee as called for under the Basle capital framework.

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 on its projections of future taxable income for that year,[23] 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 all identifiable intangible assets other than mortgage-servicing rights 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.

III. Procedures for Computing Weighted-Risk Assets and Off-Balance-Sheet Items

A. Procedures

Assets and credit-equivalent amounts of off-balance-sheet items of bank holding companies are assigned to one of several broad risk categories, according to the obligor, or, if relevant, the guarantor or the nature of the collateral. The aggregate dollar value of the amount in each category is then multiplied by the risk weight associated with that category. The resulting weighted values from each of the risk categories are added together, and this sum is the banking organization's total weighted-risk assets that comprise the denominator of the risk-based capital ratio. Attachment I provides a sample calculation.

Risk weights for all off-balance-sheet items are determined by a two-step process. First, the "credit equivalent amount" of off-balance-sheet items is determined, in most cases, by multiplying the off-balance-sheet item by a credit-conversion factor. Second, the credit-equivalent amount is treated like any balance-sheet asset and generally is assigned to the appropriate risk category according to the obligor, or, if relevant, the guarantor or the nature of the collateral.

In general, if a particular item qualifies for placement in more than one risk category, it is assigned to the category that has the lowest risk weight. A holding of a U.S. municipal revenue bond that is fully guaranteed by a U.S. bank, for example, would be assigned the 20 percent risk weight appropriate to claims guaranteed by U.S. banks, rather than the 50 percent risk weight appropriate to U.S. municipal revenue bonds.[24]

[23] 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 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 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.

[24] An investment in shares of a fund whose portfolio consists solely of various securities or money market instruments that, if held separately, would be assigned to different risk categories, is generally assigned to the risk category appropriate to the highest risk-weighted security or instrument that the fund is permitted to hold in accordance with its stated investment objectives. However, in no case will indirect holdings through shares in such funds be assigned to the zero percent risk category. For example, if a fund is permitted to hold U.S. Treasuries and commercial paper, shares in that fund would generally be assigned the 100 percent risk weight appropriate to commercial paper, regardless of the actual composition of the fund's investments at any particular time. Shares in a fund that may invest only in U.S. Treasury securities would generally be assigned to the 20 percent risk category. If, in order to maintain a necessary degree of short-term liquidity, a fund is permitted to hold an insignificant amount of its assets in short-term, highly liquid securities of superior credit quality that do not qualify for a preferential risk weight, such securities will generally not be taken into account in determining the risk category into which the banking organization's holding in the overall fund should be assigned. Regardless of the composition of the fund's securities, if the fund engages in any activities that appear speculative in nature (for example, use of futures, forwards, or option contracts for purposes other than to reduce interest-rate risk) or has any other characteristics that are inconsistent with the preferential risk weighting assigned to the fund's investments, holdings in the fund will be assigned to the 100 percent risk category. During the examination process, the treatment of shares in such funds that are assigned to a lower risk weight will be subject to examiner review to

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The terms "claims" and "securities" used in the context of the discussion of risk weights, unless otherwise specified, refer to loans or debt obligations of the entity on whom the claim is held. Assets in the form of stock or equity holdings in commercial or financial firms are assigned to the 100 percent risk category, unless some other treatment is explicitly permitted.

B. Collateral, Guarantees, and Other Considerations

1. *Collateral.* The only forms of collateral that are formally recognized by the risk-based capital framework are cash on deposit in a subsidiary lending institution; securities issued or guaranteed by the central governments of the OECD-based group of countries,[25] U.S. government agencies, or U.S. government–sponsored agencies; and securities issued by multilateral lending institutions or regional development banks. Claims fully secured by such collateral generally are assigned to the 20 percent risk category. Collateralized transactions meeting all the conditions described in section III.C.1. may be assigned a zero percent risk weight.

With regard to collateralized claims that may be assigned to the 20 percent risk-weight category, the extent to which qualifying securities are recognized as collateral is determined by their current market value. If such a claim is only partially secured, that is, the market value of the pledged securities is less than the face amount of a balance-sheet asset or an off-balance-sheet item, the portion that is covered by the market value of the qualifying collateral is assigned to the 20 percent risk category, and the portion of the claim that is not covered by collateral in the form of cash or a qualifying security is assigned to the risk category appropriate to the obligor or, if relevant, the guarantor. For example, to the extent that a claim on a private-sector obligor is collateralized by the current market value of U.S. government securities, it would be placed in the 20 percent risk category and the balance would be assigned to the 100 percent risk category.

2. *Guarantees.* Guarantees of the OECD and non-OECD central governments, U.S. government agencies, U.S. government–sponsored agencies, state and local governments of the OECD-based group of countries, multilateral lending institutions and regional development banks, U.S. depository institutions, and foreign banks are also recognized. If a claim is partially guaranteed, that is, coverage of the guarantee is less than the face amount of a balance-sheet asset or an off-balance-sheet item, the portion that is not fully covered by the guarantee is assigned to the risk category appropriate to the obligor or, if relevant, to any collateral. The face amount of a claim covered by two types of guarantees that have different risk weights, such as a U.S. government guarantee and a state guarantee, is to be apportioned between the two risk categories appropriate to the guarantors.

The existence of other forms of collateral or guarantees that the risk-based capital framework does not formally recognize may be taken into consideration in evaluating the risks inherent in an organization's loan portfolio—which, in turn, would affect the overall supervisory assessment of the organization's capital adequacy.

3. *Mortgage-backed securities.* Mortgage-backed securities, including pass-throughs and collateralized mortgage obligations (but not stripped mortgage-backed securities), that are *issued* or *guaranteed* by a U.S. government agency or U.S. government–sponsored agency are assigned to the risk-weight category appropriate to the issuer or guarantor. Generally, a privately issued mortgage-backed security meeting certain criteria set forth in

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ensure that they have been assigned an appropriate risk weight.

[25] The OECD-based group of countries comprises all full members of the Organization for Economic Cooperation and Development (OECD), as well as countries that have concluded special lending arrangements with the International Monetary Fund (IMF) associated with the Fund's General Arrangements to Borrow. The OECD includes the following countries: Australia, Austria, Belgium, Canada, Denmark, the Federal Republic of Germany, Finland, France, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. Saudi Arabia has concluded special lending arrangements with the IMF associated with the Fund's General Arrangements to Borrow.

the accompanying footnote[26] is treated as essentially an indirect holding of the underlying assets, and is assigned to the same risk category as the underlying assets, but in no case to the zero percent risk category. Privately issued mortgage-backed securities whose structures do not qualify them to be regarded as indirect holdings of the underlying assets are assigned to the 100 percent risk category. During the inspection process, privately issued mortgage-backed securities that are assigned to a lower risk-weight category will be subject to examiner review to ensure that they meet the appropriate criteria.

While the risk category to which mortgage-backed securities are assigned will generally be based upon the issuer or guarantor or, in the case of privately issued mortgage-backed securities, the assets underlying the security, any class of a mortgage-backed security that can absorb more than its pro rata share of loss without the whole issue being in default (for example, a so-called subordinated class or residual interest), is assigned to the 100 percent risk category. Furthermore, all stripped mortgage-backed securities, including interest-only strips (IOs), principal-only strips (POs), and similar instruments, are also assigned to the 100 percent risk-weight category, regardless of the issuer or guarantor.

4. *Maturity.* Maturity is generally not a factor in assigning items to risk categories with the exception of claims on non-OECD banks, commitments, and interest-rate and foreign-exchange-rate contracts. Except for commitments, short-term is defined as one year or less *remaining* maturity and long-term is defined as over one year *remaining* maturity. In the case of commitments, short-term is defined as one year or less *original* maturity and long-term is defined as over one year *original* maturity.[27]

5. *Small-business loans and leases on personal property transferred with recourse.*

a. Notwithstanding other provisions of this appendix A, a qualifying banking organization that has transferred small-business loans and leases on personal property (small-business obligations) with recourse shall include in weighted-risk assets only the amount of retained recourse, provided two conditions are met. First, the transaction must be treated as a sale under GAAP and, second, the banking organization must establish pursuant to GAAP a noncapital reserve sufficient to meet the organization's reasonably estimated liability under the recourse arrangement. Only loans and leases to businesses that meet the criteria for a small-business concern established by the Small Business Administration under section 3(a) of the Small Business Act are eligible for this capital treatment.

b. For purposes of this appendix A, a banking organization is qualifying if it meets the criteria for well capitalized or, by order of the Board, adequately capitalized, as those criteria are set forth in the Board's prompt-corrective-action regulation for state member banks (12 CFR 208.30). For purposes of determining whether an organization meets these criteria, its capital ratios must be calculated without regard to the capital treatment for transfers of small-business obligations with recourse specified in section III.B.5.a. of this appendix A. The total outstanding amount of recourse retained by a qualifying banking organization on transfers of small-business obligations receiving the

[26] A privately issued mortgage-backed security may be treated as an indirect holding of the underlying assets provided that (1) the underlying assets are held by an independent trustee and the trustee has a first priority, perfected security interest in the underlying assets on behalf of the holders of the security; (2) either the holder of the security has an undivided pro rata ownership interest in the underlying mortgage assets or the trust or single-purpose entity (or conduit) that issues the security has no liabilities unrelated to the issued securities; (3) the security is structured such that the cash flow from the underlying assets in all cases fully meets the cash-flow requirements of the security without undue reliance on any reinvestment income; and (4) there is no material reinvestment risk associated with any funds awaiting distribution to the holders of the security. In addition, if the underlying assets of a mortgage-backed security are composed of more than one type of asset, for example, U.S. government–sponsored agency securities and privately issued pass-through securities that qualify for the 50 percent risk weight category, the entire mortgage-backed security is generally assigned to the category appropriate to the highest risk-weighted asset underlying the issue, but in no case to the zero percent risk category. Thus, in this example, the security would receive the 50 percent risk weight appropriate to the privately issued pass-through securities.

[27] Through year-end 1992, remaining, rather than original, maturity may be used for determining the maturity of commitments.

preferential capital treatment cannot exceed 15 percent of the organization's total risk-based capital. By order, the Board may approve a higher limit.

c. If a bank holding company ceases to be qualifying or exceeds the 15 percent capital limitation, the preferential capital treatment will continue to apply to any transfers of small-business obligations with recourse that were consummated during the time that the organization was qualifying and did not exceed the capital limit.

C. Risk Weights

Attachment III contains a listing of the risk categories, a summary of the types of assets assigned to each category and the risk weight associated with each category, that is, 0 percent, 20 percent, 50 percent, and 100 percent. A brief explanation of the components of each category follows.

1. *Category 1: zero percent.* This category includes cash (domestic and foreign) owned and held in all offices of subsidiary depository institutions or in transit and gold bullion held in either a subsidiary depository institution's own vaults or in another's vaults on an allocated basis, to the extent it is offset by gold bullion liabilities.[28] The category also includes all direct claims (including securities, loans, and leases) on, and the portions of claims that are directly and unconditionally guaranteed by, the central governments[29] of the OECD countries and U.S. government agencies,[30] as well as all direct local currency claims on, and the portions of local currency claims that are directly and unconditionally guaranteed by, the central governments of non-OECD countries, to the extent that subsidiary depository institutions have liabilities booked in that currency. A claim is not considered to be unconditionally guaranteed by a central government if the validity of the guarantee is dependent upon some affirmative action by the holder or a third party. Generally, securities guaranteed by the U.S. government or its agencies that are actively traded in financial markets, such as GNMA securities, are considered to be unconditionally guaranteed.

This category also includes claims collateralized by cash on deposit in the subsidiary lending institution or by securities issued or guaranteed by OECD central governments or U.S. government agencies for which a positive margin of collateral is maintained on a daily basis, fully taking into account any change in the banking organization's exposure to the obligor or counterparty under a claim in relation to the market value of the collateral held in support of that claim.

2. *Category 2: 20 percent.* This category includes cash items in the process of collection, both foreign and domestic; short-term claims (including demand deposits) on, and the portions of short-term claims that are guaranteed by,[31] U.S. depository institutions[32] and foreign

[28] All other holdings of bullion are assigned to the 100 percent risk category.

[29] A central government is defined to include departments and ministries, including the central bank, of the central government. The U.S. central bank includes the 12 Federal Reserve Banks, and stock held in these banks as a condition of membership is assigned to the zero percent risk category. The definition of central government does not include state, provincial, or local governments; or commercial enterprises owned by the central government. In addition, it does not include local government entities or commercial enterprises whose obligations are guaranteed by the central government, although any claims on such entities guaranteed by central governments are placed in the same general risk category as other claims guaranteed by central governments. OECD central governments are defined as central governments of the OECD-based group of countries; non-OECD central governments are defined as central governments of countries that do not belong to the OECD-based group of countries.

[30] A U.S. government agency is defined as an instrumentality of the U.S. government whose obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. government. Such agencies include the Government National Mortgage Association (GNMA), the Veterans Administration (VA), the Federal Housing Administration (FHA), the Export-Import Bank (Exim Bank), the Overseas Private Investment Corporation (OPIC), the Commodity Credit Corporation (CCC), and the Small Business Administration (SBA).

[31] Claims guaranteed by U.S. depository institutions and foreign banks include risk participations in both banker's acceptances and standby letters of credit, as well as participations in commitments, that are conveyed to U.S. depository institutions or foreign banks.

[32] U.S. depository institutions are defined to include branches (foreign and domestic) of federally insured banks and depository institutions chartered and headquartered in the 50 states of the United States, the District of Columbia, Puerto Rico, and U.S. territories and possessions. The definition encompasses banks, mutual or stock savings banks, savings or building and loan associations, cooperative banks, credit unions, and international banking facilities of domestic banks. U.S.-chartered depository institutions owned by foreigners are also included in the definition.

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banks;[33] and long-term claims on, and the portions of long-term claims that are guaranteed by, U.S. depository institutions and OECD banks.[34]

This category also includes the portions of claims that are conditionally guaranteed by OECD central governments and U.S. government agencies, as well as the portions of local currency claims that are conditionally guaranteed by non-OECD central governments, to the extent that subsidiary depository institutions have liabilities booked in that currency. In addition, this category also includes claims on, and the portions of claims that are guaranteed by, U.S. government–sponsored agencies[35] and claims on, and the portions of claims guaranteed by, the International Bank for Reconstruction and Development (World Bank), the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Investment Bank, the European Bank for Reconstruction and Development, the Nordic Investment Bank, and other multilateral lending institutions or regional development banks in which the U.S. government is a shareholder or contributing member. General obligation claims on, or portions of claims guaranteed by the full faith and credit of, states or other political subdivisions of the United States or other countries of the OECD-based group are also assigned to this category.[36]

This category also includes the portions of claims (including repurchase transactions) collateralized by cash on deposit in the subsidiary lending institution or by securities issued or guaranteed by OECD central governments or U.S. government agencies that do not qualify for the zero percent risk-weight category; collateralized by securities issued or guaranteed by U.S. government–sponsored agencies; or collateralized by securities issued by multilateral lending institutions or regional development banks in which the U.S. government is a shareholder or contributing member.

3. *Category 3: 50 percent.* This category includes loans fully secured by first liens[37] on one- to four-family residential properties, either owner-occupied or rented, or on multifamily residential properties,[38] that meet certain criteria.[39] Loans included in this category must have been made in accordance with prudent underwriting standards;[40] be performing

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However, branches and agencies of foreign banks located in the U.S., as well as all bank holding companies, are excluded.

33 Foreign banks are distinguished as either OECD banks or non-OECD banks. OECD banks include banks and their branches (foreign and domestic) organized under the laws of countries (other than the U.S.) that belong to the OECD-based group of countries. Non-OECD banks include banks and their branches (foreign and domestic) organized under the laws of countries that do not belong to the OECD-based group of countries. For this purpose, a bank is defined as an institution that engages in the business of banking; is recognized as a bank by the bank supervisory or monetary authorities of the country of its organization or principal banking operations; receives deposits to a substantial extent in the regular course of business; and has the power to accept demand deposits.

34 Long-term claims on, or guaranteed by, non-OECD banks and all claims on bank holding companies are assigned to the 100 percent risk category, as are holdings of bank-issued securities that qualify as capital of the issuing banks.

35 For this purpose, U.S. government–sponsored agencies are defined as agencies originally established or chartered by the federal government to serve public purposes specified by the U.S. Congress but whose obligations are *not explicitly* guaranteed by the full faith and credit of the U.S. government. These agencies include the Federal Home Loan Mortgage Corporation (FHLMC), the Federal National Mortgage Association (FNMA), the Farm Credit System, the Federal Home Loan Bank System, and the Student Loan Marketing Association (SLMA). Claims on U.S. government–sponsored agencies include capital stock in a Federal Home Loan Bank that is held as a condition of membership in that Bank.

36 Claims on, or guaranteed by, states or other political subdivisions of countries that do not belong to the OECD-based group of countries are placed in the 100 percent risk category.

37 If a banking organization holds the first and junior lien(s) on a residential property and no other party holds an intervening lien, the transaction is treated as a single loan secured by a first lien for the purpose of determining the loan-to-value ratio.

38 Loans that qualify as loans secured by one- to four-family residential properties or multifamily residential properties are listed in the instructions to the FR Y-9C Report. In addition, for risk-based capital purposes, loans secured by one- to four-family residential properties include loans to builders with substantial project equity for the construction of one- to four-family residences that have been presold under firm contracts to purchasers who have obtained firm commitments for permanent qualifying mortgage loans and have made substantial earnest money deposits.

39 Residential property loans that do not meet all the specified criteria or that are made for the purpose of speculative property development are placed in the 100 percent risk category.

40 Prudent underwriting standards include a conservative ratio of the current loan balance to the value of the property. In the case of a loan secured by multifamily residential property, the loan-to-value ratio is not conservative if it
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in accordance with their original terms; and not be 90 days or more past due or carried in nonaccrual status. The following additional criteria must also be applied to a loan secured by a multifamily residential property that is included in this category: all principal and interest payments on the loan must have been made on time for at least the year preceding placement in this category, or in the case where the existing property owner is refinancing a loan on that property, all principal and interest payments on the loan being refinanced must have been made on time for at least the year preceding placement in this category; amortization of the principal and interest may occur over a period of not more than 30 years and the minimum original maturity for repayment of principal must not be less than 7 years; and the annual net operating income (before debt service) generated by the property during its most recent fiscal year must not be less than 120 percent of the loan's current annual debt service (115 percent if the loan is based on a floating interest rate) or, in the case of a cooperative or other not-for-profit housing project, the property must generate sufficient cash flow to provide comparable protection to the institution. Also included in this category are privately issued mortgage-backed securities provided that (1) the structure of the security meets the criteria described in section III(B)(3) above; (2) if the security is backed by a pool of conventional mortgages, on one- to four-family residential or multifamily residential properties, *each* underlying mortgage meets the criteria described above in this section for eligibility for the 50 percent risk category at the time the pool is originated; (3) if the security is backed by privately issued mortgage-backed securities, *each* underlying security qualifies for the 50 percent risk category; and (4) if the security is backed by a pool of multifamily residential mortgages, principal and interest payments on the security are not 30 days or more past due. Privately issued mortgage-backed securities that do not meet these criteria or that do not qualify for a lower risk weight are generally assigned to the 100 percent risk category.

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exceeds 80 percent (75 percent if the loan is based on a floating interest rate). Prudent underwriting standards also dictate that a loan-to-value ratio used in the case of originating a loan to acquire a property would not be deemed conservative unless the value is based on the lower of the acquisition cost of the property or appraised (or if appropriate, evaluated) value. Otherwise, the loan-to-value ratio generally would be based upon the value of the property as determined by the most current appraisal, or if appropriate, the most current evaluation. All appraisals must be made in a manner consistent with the federal banking agencies' real estate appraisal regulations and guidelines and with the banking organization's own appraisal guidelines.

Also assigned to this category are *revenue* (nongeneral obligation) bonds or similar obligations, including loans and leases, that are obligations of states or other political subdivisions of the United States (for example, municipal revenue bonds) or other countries of the OECD-based group, but for which the government entity is committed to repay the debt with revenues from the specific projects financed, rather than from general tax funds.

Credit-equivalent amounts of derivative contracts involving standard risk obligors (that is, obligors whose loans or debt securities would be assigned to the 100 percent risk category) are included in the 50 percent category, unless they are backed by collateral or guarantees that allow them to be placed in a lower risk category.

4. *Category 4: 100 percent.* All assets not included in the categories above are assigned to this category, which comprises standard risk assets. The bulk of the assets typically found in a loan portfolio would be assigned to the 100 percent category.

This category includes long-term claims on, and the portions of long-term claims that are guaranteed by, non-OECD banks, and all claims on non-OECD central governments that entail some degree of transfer risk.[41] This category also includes all claims on foreign and domestic private-sector obligors not included in the categories above (including loans to nondepository financial institutions and bank holding companies); claims on commercial firms owned by the public sector; customer liabilities to the bank on acceptances outstand-

[41] Such assets include all nonlocal-currency claims on, and the portions of claims that are guaranteed by, non-OECD central governments and those portions of local-currency claims on, or guaranteed by, non-OECD central governments that exceed the local-currency liabilities held by subsidiary depository institutions.

ing involving standard risk claims;[42] investments in fixed assets, premises, and other real estate owned; common and preferred stock of corporations, including stock acquired for debts previously contracted; commercial and consumer loans (except those assigned to lower risk categories due to recognized guarantees or collateral and loans for residential property that qualify for a lower risk weight); mortgage-backed securities that do not meet criteria for assignment to a lower risk weight (including any classes of mortgage-backed securities that can absorb more than their pro rata share of loss without the whole issue being in default); and all stripped mortgage-backed and similar securities.

Also included in this category are industrial-development bonds and similar obligations issued under the auspices of states or political subdivisions of the OECD-based group of countries for the benefit of a private party or enterprise where that party or enterprise, not the government entity, is obligated to pay the principal and interest, and all obligations of states or political subdivisions of countries that do not belong to the OECD-based group.

The following assets also are assigned a risk weight of 100 percent if they have not been deducted from capital: investments in unconsolidated companies, joint ventures, or associated companies; instruments that qualify as capital issued by other banking organizations; and any intangibles, including those that may have been grandfathered into capital.

D. Off-Balance-Sheet Items

The face amount of an off-balance-sheet item is incorporated into the risk-based capital ratio by multiplying it by a credit-conversion factor. The resultant credit-equivalent amount is assigned to the appropriate risk category according to the obligor, or, if relevant, the guarantor or the nature of the collateral.[43] Attachment IV sets forth the conversion factors for various types of off-balance-sheet items.

1. *Items with a 100 percent conversion factor.*
   a. A 100 percent conversion factor applies to direct credit substitutes, which include guarantees, or equivalent instruments, backing financial claims, such as outstanding securities, loans, and other financial liabilities, or that back off-balance-sheet items that require capital under the risk-based capital framework. Direct credit substitutes include, for example, financial standby letters of credit, or other equivalent irrevocable undertakings or surety arrangements, that guarantee repayment of financial obligations such as commercial paper, tax-exempt securities, commercial or individual loans or debt obligations, or standby or commercial letters of credit. Direct credit substitutes also include the acquisition of risk participations in banker's acceptances and standby letters of credit, since both of these transactions, in effect, constitute a guarantee by the acquiring banking organization that the underlying account party (obligor) will repay its obligation to the originating, or issuing, institution.[44] (Standby letters of credit that are performance related are discussed below and have a credit-conversion factor of 50 percent.)
   b. The full amount of a direct credit substitute is converted at 100 percent and the resulting credit-equivalent amount is assigned to the risk category appropriate to the obligor or, if relevant, the guarantor or the nature of the collateral. In the case of a direct credit substitute in which a risk participation[45] has been conveyed, the full

[42] Customer liabilities on acceptances outstanding involving nonstandard risk claims, such as claims on U.S. depository institutions, are assigned to the risk category appropriate to the identity of the obligor or, if relevant, the nature of the collateral or guarantees backing the claims. Portions of acceptances conveyed as risk participations to U.S. depository institutions or foreign banks are assigned to the 20 percent risk category appropriate to short-term claims guaranteed by U.S. depository institutions and foreign banks.

[43] The sufficiency of collateral and guarantees for off-balance-sheet items is determined by the market value of the collateral or the amount of the guarantee in relation to the face amount of the item, except for interest- and foreign-exchange-rate contracts, for which this determination is made in relation to the credit-equivalent amount. Collateral and guarantees are subject to the same provisions noted under section III(B).

[44] Credit-equivalent amounts of acquisitions of risk participations are assigned to the risk category appropriate to the account-party obligor, or, if relevant, the nature of the collateral or guarantees.

[45] That is, a participation in which the originating bank-

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amount is still converted at 100 percent. However, the credit-equivalent amount that has been conveyed is assigned to whichever risk category is lower: the risk category appropriate to the obligor, after giving effect to any relevant guarantees or collateral, or the risk category appropriate to the institution acquiring the participation. Any remainder is assigned to the risk category appropriate to the obligor, guarantor, or collateral. For example, the portion of a direct credit substitute conveyed as a risk participation to a U.S. domestic depository institution or foreign bank is assigned to the risk category appropriate to claims guaranteed by those institutions, that is, the 20 percent risk category.[46] This approach recognizes that such conveyances replace the originating banking organization's exposure to the obligor with an exposure to the institutions acquiring the risk participations.[47]

c. In the case of direct credit substitutes that take the form of a syndication, that is, where each banking organization is obligated only for its pro rata share of the risk and there is no recourse to the originating banking organization, each banking organization will only include its pro rata share of the direct credit substitute in its risk-based capital calculation.

d. Financial standby letters of credit are distinguished from loan commitments (discussed below) in that standbys are irrevocable obligations of the banking organization to pay a third-party beneficiary when a customer (account party) *fails to repay* an outstanding loan or debt instrument (direct credit substitute). Performance standby letters of credit (performance bonds) are irrevocable obligations of the banking organization to pay a third-party beneficiary when a customer (account party) *fails to perform* some other contractual nonfinancial obligation.

e. The distinguishing characteristic of a standby letter of credit for risk-based capital purposes is the combination of irrevocability with the fact that funding is triggered by some failure to repay or perform an obligation. Thus, any commitment (by whatever name) that involves an *irrevocable* obligation to make a payment to the customer or to a third party in the event the customer *fails to repay* an outstanding debt obligation or *fails to perform* a contractual obligation is treated, for risk-based capital purposes, as respectively, a financial guarantee standby letter of credit or a performance standby.

f. A loan commitment, on the other hand, involves an obligation (with or without a material adverse change or similar clause) of the banking organization to fund its customer *in the normal course* of business should the customer seek to draw down the commitment.

g. Sale and repurchase agreements and asset sales with recourse (to the extent not included on the balance sheet) and forward agreements also are converted at 100 percent.[48] So-called "loan strips" (that is,

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ing organization remains liable to the beneficiary for the full amount of the direct credit substitute if the party that has acquired the participation fails to pay when the instrument is drawn.

[46] Risk participations with a remaining maturity of over one year that are conveyed to non-OECD banks are to be assigned to the 100 percent risk category, unless a lower risk category is appropriate to the obligor, guarantor, or collateral.

[47] A risk participation in banker's acceptances conveyed to other institutions is also assigned to the risk category appropriate to the institution acquiring the participation or, if relevant, the guarantor or nature of the collateral.

[48] In regulatory reports and under GAAP, bank holding companies are permitted to treat some asset sales with recourse as "true" sales. For risk-based capital purposes, however, such assets sold with recourse and reported as "true" sales by bank holding companies are converted at 100 percent and assigned to the risk category appropriate to the underlying obligor or, if relevant, the guarantor or nature of the collateral, provided that the transactions meet the definition of assets sold with recourse (including assets sold subject to pro rata and other loss-sharing arrangements), that is contained in the instructions to the commercial bank Consolidated Reports of Condition and Income (call report). This treatment applies to any assets, including the sale of one- to four-family and multifamily residential mortgages, sold with recourse. Accordingly, the entire amount of any assets transferred with recourse that are not already included on the balance sheet, including pools of one- to four-family residential mortgages, are to be converted at 100 percent and assigned to the risk category appropriate to the obligor or, if relevant, the nature of any collateral or guarantees. The terms of a transfer of assets with recourse may contractually limit the amount of the institution's liability to an amount less than the effective risk-based capital requirement for the assets being transferred with recourse. If such a transaction is recognized as a sale under GAAP, the amount of total capital required is equal to the maximum amount of loss possible under the recourse provision, less any amount held in an associated non–capital liability account established pursuant to GAAP

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short-term advances sold under long-term commitments without direct recourse) are treated for risk-based capital purposes as assets sold with recourse and, accordingly, are also converted at 100 percent.

h. Forward agreements are legally binding contractual obligations to purchase assets with *certain* drawdown at a specified future date. Such obligations include forward purchases, forward forward deposits placed,[49] and partly paid shares and securities; they do not include commitments to make residential mortgage loans or forward foreign-exchange contracts.

i. Securities lent by a banking organization are treated in one of two ways, depending upon whether the lender is at risk of loss. If a banking organization, as agent for a customer, lends the customer's securities and does not indemnify the customer against loss, then the transaction is excluded from the risk-based capital calculation. If, alternatively, a banking organization lends its own securities or, acting as agent for a customer, lends the customer's securities and indemnifies the customer against loss, the transaction is converted at 100 percent and assigned to the risk-weight category appropriate to the obligor, to any collateral delivered to the lending banking organization, or, if applicable, to the independent custodian acting on the lender's behalf. Where a banking organization is acting as agent for a customer in a transaction involving the lending or sale of securities that is collateralized by cash delivered to the banking organization, the transaction is deemed to be collateralized by cash on deposit in a subsidiary lending institution for purposes of determining the appropriate risk-weight category, provided that any indemnification is limited to no more than the difference between the market value of the securities and the cash collateral received and any reinvestment risk associated with that cash collateral is borne by the customer.

2. *Items with a 50 percent conversion factor.* Transaction-related contingencies are converted at 50 percent. Such contingencies include bid bonds, performance bonds, warranties, standby letters of credit related to particular transactions, and performance standby letters of credit, as well as acquisitions of risk participations in performance standby letters of credit. Performance standby letters of credit represent obligations backing the performance of nonfinancial or commercial contracts or undertakings. To the extent permitted by law or regulation, performance standby letters of credit include arrangements backing, among other things, subcontractors' and suppliers' performance, labor and materials contracts, and construction bids.

The unused portion of commitments with an *original* maturity exceeding one year,[50] including underwriting commitments, and commercial and consumer credit commitments also are converted at 50 percent. Original maturity is defined as the length of time between the date the commitment is issued and the earliest date on which (1) the banking organization can, at its option, unconditionally (without cause) cancel the commitment[51] and (2) the banking organization is scheduled to (and as a normal practice actually does) review the facility to determine whether or not it should be extended. Such reviews must continue to be conducted at least annually for such a facility to qualify as a short-term commitment.

Commitments are defined as any legally binding arrangements that obligate a banking organization to extend credit in the form of loans or leases; to purchase loans, securities, or other assets; or to participate in loans and leases. They also include overdraft facilities, revolving credit, home equity and mortgage lines of credit, and similar transactions. Normally, commitments involve a written contract or agreement and a commitment fee, or some

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to cover estimated probable losses under the recourse provision.

49 Forward forward deposits accepted are treated as interest-rate contracts.

50 Through year-end 1992, remaining maturity may be used for determining the maturity of off-balance-sheet loan commitments; thereafter, original maturity must be used.

51 In the case of consumer home-equity or mortgage lines of credit secured by liens on one- to four-family residential properties, the bank is deemed able to unconditionally cancel the commitment for the purpose of this criterion if, at its option, it can prohibit additional extensions of credit, reduce the credit line, and terminate the commitment to the full extent permitted by relevant federal law.

other form of consideration. Commitments are included in weighted-risk assets regardless of whether they contain "material adverse change" clauses or other provisions that are intended to relieve the issuer of its funding obligation under certain conditions. In the case of commitments structured as syndications, where the banking organization is obligated solely for its pro rata share, only the banking organization's proportional share of the syndicated commitment is taken into account in calculating the risk-based capital ratio.

Facilities that are unconditionally cancellable (without cause) at any time by the banking organization are not deemed to be commitments, provided the banking organization makes a separate credit decision before each drawing under the facility. Commitments with an original maturity of one year or less are deemed to involve low risk and, therefore, are not assessed a capital charge. Such short-term commitments are defined to include the unused portion of lines of credit on retail credit cards and related plans (as defined in the instructions to the FR Y-9C Report) if the banking organization has the unconditional right to cancel the line of credit at any time, in accordance with applicable law.

Once a commitment has been converted at 50 percent, any portion that has been conveyed to U.S. depository institutions or OECD banks as participations in which the originating banking organization retains the full obligation to the borrower if the participating bank fails to pay when the instrument is drawn, is assigned to the 20 percent risk category. This treatment is analogous to that accorded to conveyances of risk participations in standby letters of credit. The acquisition of a participation in a commitment by a banking organization is converted at 50 percent and assigned to the risk category appropriate to the account-party obligor or, if relevant, the nature of the collateral or guarantees.

Revolving underwriting facilities (RUFs), note-issuance facilities (NIFs), and other similar arrangements also are converted at 50 percent regardless of maturity. These are facilities under which a borrower can issue on a revolving basis short-term paper in its own name, but for which the underwriting organizations have a legally binding commitment either to purchase any notes the borrower is unable to sell by the rollover date or to advance funds to the borrower.

3. *Items with a 20 percent conversion factor.* Short-term, self-liquidating, trade-related contingencies which arise from the movement of goods are converted at 20 percent. Such contingencies generally include commercial letters of credit and other documentary letters of credit collateralized by the underlying shipments.

4. *Items with a zero percent conversion factor.* These include unused portions of commitments with an original maturity of one year or less,[52] or which are unconditionally cancellable at any time, provided a separate credit decision is made before each drawing under the facility. Unused portions of lines of credit on retail credit cards and related plans are deemed to be short-term commitments if the banking organization has the unconditional right to cancel the line of credit at any time, in accordance with applicable law.

E. Derivative Contracts (Interest-Rate, Exchange-Rate, Commodity- (Including Precious Metals) and Equity-Linked Contracts)

1. *Scope.* Credit-equivalent amounts are computed for each of the following off-balance-sheet derivative contracts:

a. Interest-rate contracts. These include single-currency interest-rate swaps, basis swaps, forward rate agreements, interest-rate options purchased (including caps, collars, and floors purchased), and any other instrument linked to interest rates that gives rise to similar credit risks (including when-issued securities and forward forward deposits accepted).

b. Exchange-rate contracts. These include cross-currency interest-rate swaps, forward foreign-exchange contracts, currency options purchased, and any other instrument

[52] Through year-end 1992, remaining maturity may be used for determining term to maturity for off-balance-sheet loan commitments; thereafter, original maturity must be used.

linked to exchange rates that gives rise to similar credit risks.

c. Equity derivative contracts. These include equity-linked swaps, equity-linked options purchased, forward equity-linked contracts, and any other instrument linked to equities that gives rise to similar credit risks.

d. Commodity (including precious metal) derivative contracts. These include commodity-linked swaps, commodity-linked options purchased, forward commodity-linked contracts, and any other instrument linked to commodities that gives rise to similar credit risks.

e. Exceptions. Exchange-rate contracts with an original maturity of 14 or fewer calendar days and derivative contracts traded on exchanges that require daily receipt and payment of cash variation margin may be excluded from the risk-based ratio calculation. Gold contracts are accorded the same treatment as exchange-rate contracts except that gold contracts with an original maturity of 14 or fewer calendar days are included in the risk-based ratio calculation. Over-the-counter options purchased are included and treated in the same way as other derivative contracts.

2. *Calculation of credit-equivalent amounts.*

a. The credit-equivalent amount of a derivative contract that is not subject to a qualifying bilateral netting contract in accordance with section III.E.3. of this appendix A is equal to the sum of (i) the current exposure (sometimes referred to as the replacement cost) of the contract; and (ii) an estimate of the potential future credit exposure of the contract.

b. The current exposure is determined by the mark-to-market value of the contract. If the mark-to-market value is positive, then the current exposure is that mark-to-market value. If the mark-to-market value is zero or negative, then the current exposure is zero. Mark-to-market values are measured in dollars, regardless of the currency or currencies specified in the contract, and should reflect changes in underlying rates, prices, and indices, as well as counterparty credit quality.

c. The potential future credit exposure of a contract, including a contract with a negative mark-to-market value, is estimated by multiplying the notional principal amount of the contract by a credit-conversion factor. Banking organizations should use, subject to examiner review, the effective rather than the apparent or stated notional amount in this calculation. The conversion factors are:

Conversion Factors
(in percent)

Remaining maturity	*Interest-rate*	*Exchange-rate and gold*	*Equity*	*Commodity, excluding precious metals*	*Precious metals, except gold*
One year or less	0.0	1.0	6.0	10.0	7.0
Over one to five years	0.5	5.0	8.0	12.0	7.0
Over five years	1.5	7.5	10.0	15.0	8.0

d. For a contract that is structured such that on specified dates any outstanding exposure is settled and the terms are reset so that the market value of the contract is zero, the remaining maturity is equal to the time until the next reset date. For an interest-rate contract with a remaining maturity of more than one year that meets these criteria, the minimum conversion factor is 0.5 percent.

e. For a contract with multiple exchanges of principal, the conversion factor is multiplied by the number of remaining payments in the contract. A derivative contract not included in the definitions of interest-rate, exchange-rate, equity, or commodity contracts as set forth in section III.E.1. of this appendix A is subject to the same conversion factors as a commodity, excluding precious metals.

f. No potential future exposure is calculated for a single-currency interest-rate swap in which payments are made based upon two floating-rate indices (a so-called floating/floating or basis swap); the credit exposure on such a contract is evaluated solely on the basis of the mark-to-market value.

g. The Board notes that the conversion factors set forth above, which are based on observed volatilities of the particular types of instruments, are subject to review and modification in light of changing volatilities or market conditions.

3. *Netting.*

a. For purposes of this appendix A, netting refers to the offsetting of positive and negative mark-to-market values when determining a current exposure to be used in the calculation of a credit-equivalent amount. Any legally enforceable form of bilateral netting (that is, netting with a single counterparty) of derivative contracts is recognized for purposes of calculating the credit-equivalent amount provided that—

i. the netting is accomplished under a written netting contract that creates a single legal obligation, covering all included individual contracts, with the effect that the organization would have a claim to receive, or obligation to pay, only the net amount of the sum of the positive and negative mark-to-market values on included individual contracts in the event that a counterparty, or a counterparty to whom the contract has been validly assigned, fails to perform due to any of the following events: default, bankruptcy, liquidation, or similar circumstances;

ii. the banking organization obtains a written and reasoned legal opinion(s) representing that in the event of a legal challenge—including one resulting from default, bankruptcy, liquidation, or similar circumstances—the relevant court and administrative authorities would find the banking organization's exposure to be the net amount under—

1. the law of the jurisdiction in which the counterparty is chartered or the equivalent location in the case of noncorporate entities, and if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located;

2. the law that governs the individual contracts covered by the netting contract; and

3. the law that governs the netting contract;

iii. the banking organization establishes and maintains procedures to ensure that the legal characteristics of netting contracts are kept under review in the light of possible changes in relevant law; and

iv. the banking organization maintains in its files documentation adequate to support the netting of derivative contracts, including a copy of the bilateral netting contract and necessary legal opinions.

b. A contract containing a walkaway clause is not eligible for netting for purposes of calculating the credit-equivalent amount.[53]

c. A banking organization netting individual contracts for the purpose of calculating credit-equivalent amounts of derivative contracts represents that it has met the requirements of this appendix A and all the appropriate documents are in the organization's files and available for inspection by the Federal Reserve. The Federal Reserve may determine that a banking organization's files are inadequate or that a netting contract, or any of its underlying individual contracts, may not be legally enforceable under any one of the bodies of law described in section III.E.3.a.ii. of this appendix A. If such a determination is made, the netting contract may be disqualified from recognition for risk-based capital purposes or underlying individual contracts may be treated as though they are not subject to the netting contract.

d. The credit-equivalent amount of contracts that are subject to a qualifying bilateral netting contract is calculated by adding (i) the current exposure of the netting contract (net current exposure) and (ii) the sum of the estimates of potential future credit

[53] A walkaway clause is a provision in a netting contract that permits a nondefaulting counterparty to make lower payments than it would make otherwise under the contract, or no payment at all, to a defaulter or to the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the contract.

exposures on all individual contracts subject to the netting contract (gross potential future exposure) adjusted to reflect the effects of the netting contract.[54]

e. The net current exposure is the sum of all positive and negative mark-to-market values of the individual contracts included in the netting contract. If the net sum of the mark-to-market values is positive, then the net current exposure is equal to that sum. If the net sum of the mark-to-market values is zero or negative, then the current exposure is zero. The Federal Reserve may determine that a netting contract qualifies for risk-based capital netting treatment even though certain individual contracts included under the netting contract may not qualify. In such instances, the nonqualifying contracts should be treated as individual contracts that are not subject to the netting contract.

f. Gross potential future exposure, or A_{gross} is calculated by summing the estimates of potential future exposure (determined in accordance with section III.E.2 of this appendix A) for each individual contract subject to the qualifying bilateral netting contract.

g. The effects of the bilateral netting contract on the gross potential future exposure are recognized through the application of a formula that results in an adjusted add-on amount (A_{net}). The formula, which employs the ratio of net current exposure to gross current exposure (NGR), is expressed as:

$$A_{net} = (0.4 \times A_{gross}) + 0.6\ (NGR \times A_{gross})$$

h. The NGR may be calculated in accordance with either the counterparty-by-counterparty approach or the aggegate approach.

i. Under the counterparty-by-counterparty approach, the NGR is the ratio of the net current exposure for a netting contract to the gross current exposure of the netting contract. The gross current exposure is the sum of the current exposures of all individual contracts subject to the netting contract calculated in accordance with section III.E.2. of this appendix A. Net negative mark-to-market values for individual netting contracts with the same counterparty may not be used to offset net positive mark-to-market values for other netting contracts with the same counterparty.

ii. Under the aggregate approach, the NGR is the ratio of the sum of all of the net current exposures for qualifying bilateral netting contracts to the sum of all of the gross current exposures for those netting contracts (each gross current exposure is calculated in the same manner as in section III.E.3.h.i. of this appendix A). Net negative mark-to-market values for individual counterparties may not be used to offset net positive current exposures for other counterparties.

iii. A banking organization must use consistently either the counterparty-by-counterparty approach or the aggregate approach to calculate the NGR. Regardless of the approach used, the NGR should be applied individually to each qualifying bilateral netting contract to determine the adjusted add-on for that netting contract.

i. In the event a netting contract covers contracts that are normally excluded from the risk-based ratio calculation—for example, exchange-rate contracts with an original maturity of 14 or fewer calendar days or instruments traded on exchanges that require daily payment and receipt of cash variation margin—an institution may elect to either include or exclude all mark-to-market values of such contracts when determining net current exposure, provided the method chosen is applied consistently.

4. *Risk weights.* Once the credit-equivalent amount for a derivative contract, or a group of derivative contracts subject to a qualifying bilateral netting contract, has been determined, that amount is assigned to the risk category appropriate to the counterparty, or, if relevant, the guarantor or the nature of any collateral.[55]

[54] For purposes of calculating potential future credit exposure to a netting counterparty for foreign-exchange contracts and other similar contracts in which notional principal is equivalent to cash flows, total notional principal is defined as the net receipts falling due on each value date in each currency.

[55] For derivative contracts, sufficiency of collateral or guarantees is generally determined by the market value of

Continued

However, the maximum risk weight applicable to the credit-equivalent amount of such contracts is 50 percent.

5. *Avoidance of double-counting.*

a. In certain cases, credit exposures arising from the derivative contracts covered by section III.E. of this appendix A may already be reflected, in part, on the balance sheet. To avoid double-counting such exposures in the assessment of capital adequacy and, perhaps, assigning inappropriate risk weights, counterparty credit exposures arising from the derivative instruments covered by these guidelines may need to be excluded from balance-sheet assets in calculating a banking organization's risk-based capital ratios.

b. Examples of the calculation of credit-equivalent amounts for contracts covered under this section III.E. are contained in attachment V of this appendix A.

IV. Minimum Supervisory Ratios and Standards

The interim and final supervisory standards set forth below specify *minimum* supervisory ratios based primarily on broad credit-risk considerations. As noted above, the risk-based ratio does not take explicit account of the quality of individual asset portfolios or the range of other types of risks to which banking organizations may be exposed, such as interest-rate, liquidity, market, or operational risks. For this reason, banking organizations are generally expected to operate with capital positions well above the minimum ratios. Institutions with high or inordinate levels of risk are expected to operate well above minimum capital standards. Banking organizations experiencing or anticipating significant growth are also expected to maintain capital, including tangible capital positions, well above the minimum levels. For example, most such organizations generally have operated at capital levels ranging from 100 to 200 basis points above the stated minimums. Higher capital ratios could be required if warranted by the particular circumstances or risk profiles of individual banking organizations. In all cases, organizations should hold capital commensurate with the level and nature of all of the risks, including the volume and severity of problem loans, to which they are exposed.

Upon adoption of the risk-based framework, any organization that does not meet the interim or final supervisory ratios, or whose capital is otherwise considered inadequate, is expected to develop and implement a plan acceptable to the Federal Reserve for achieving an adequate level of capital consistent with the provisions of these guidelines or with the special circumstances affecting the individual organization. In addition, such organizations should avoid any actions, including increased risk-taking or unwarranted expansion, that would lower or further erode their capital positions.

A. Minimum Risk-Based Ratio After Transition Period

As reflected in attachment VI, by year-end 1992, all bank holding companies[56] should meet a minimum ratio of qualifying total capital to weighted-risk assets of 8 percent, of which at least 4.0 percentage points should be in the form of tier 1 capital. For purposes of section IV.A., tier 1 capital is defined as the sum of core capital elements less goodwill and other intangible assets required to be deducted in accordance with section II.B.1.b. of this appendix. The maximum amount of supplementary capital elements that qualifies as tier 2 capital is limited to 100 percent of tier 1 capital. In addition, the combined maximum amount of subordinated debt and intermediate-term preferred stock that qualifies as tier 2 capital is limited to 50 percent of tier 1 capital. The maximum amount of the allowance for loan and lease losses that qualifies as tier 2 capital is limited to 1.25 percent of gross weighted-risk assets. Allowances for loan and lease losses in excess of this limit may, of course, be maintained, but would not

Continued

the collateral or the amount of the guarantee in relation to the credit-equivalent amount. Collateral and guarantees are subject to the same provisions noted under section III.B. of this appendix A.

[56] As noted in section I above, bank holding companies with less than $150 million in consolidated assets would generally be exempt from the calculation and analysis of risk-based ratios on a consolidated holding company basis, subject to certain terms and conditions.

be included in an organization's total capital. The Federal Reserve will continue to require bank holding companies to maintain reserves at levels fully sufficient to cover losses inherent in their loan portfolios.

Qualifying total capital is calculated by adding tier 1 capital and tier 2 capital (limited to 100 percent of tier 1 capital) and then deducting from this sum certain investments in banking or finance subsidiaries that are not consolidated for accounting or supervisory purposes, reciprocal holdings of banking organizations' capital securities, or other items at the direction of the Federal Reserve. The conditions under which these deductions are to be made and the procedures for making the deductions are discussed above in section II(B).

B. Transition Arrangements

The transition period for implementing the risk-based capital standard ends on December 31, 1992.[57] Initially, the risk-based capital guidelines do not establish a minimum level of capital. However, by year-end 1990, banking organizations are expected to meet a minimum interim target ratio for qualifying total capital to weighted-risk assets of 7.25 percent, at least one-half of which should be in the form of tier 1 capital. For purposes of meeting the 1990 interim target, the amount of loan-loss reserves that may be included in capital is limited to 1.5 percent of weighted-risk assets and up to 10 percent of an organization's tier 1 capital may consist of supplementary capital elements. Thus, the 7.25 percent interim target ratio implies a minimum ratio of tier 1 capital to weighted-risk assets of 3.6 percent (one-half of 7.25) and a minimum ratio of core capital elements to weighted-risk assets ratio of 3.25 percent (nine-tenths of the tier 1 capital ratio).

Through year-end 1990, banking organizations have the option of complying with the minimum 7.25 percent year-end 1990 risk-based capital standard, in lieu of the minimum 5.5 percent primary and 6 percent total capital to total assets ratios set forth in appendix B of this part. In addition, as more fully set forth in appendix D to this part. banking organizations are expected to maintain a minimum ratio or tier 1 capital to total assets during this transition period.

[57] The Basle capital framework does not establish an initial minimum standard for the risk-based capital ratio before the end of 1990. However, for the purpose of calculating a risk-based capital ratio prior to year-end 1990, no sublimit is placed on the amount of the allowance for loan and lease losses includable in tier 2. In addition, this framework permits, under temporary transition arrangements, a certain percentage of an organization's tier 1 capital to be made up of supplementary capital elements. In particular, supplementary elements may constitute 25 percent of an organization's tier 1 capital (before the deduction of goodwill) up to the end of 1990; from year-end 1990 up to the end of 1992, this allowable percentage of supplementary elements in tier 1 declines to 10 percent of tier 1 (before the deduction of goodwill). Beginning on December 31, 1992, supplementary elements may not be included in tier 1. The amount of subordinated debt and intermediate-term preferred stock temporarily included in tier 1 under these arrangements will not be subject to the sublimit on the amount of such instruments includable in tier 2 capital. While the transitional arrangements allow an organization to include supplementary elements in tier 1 on a temporary basis, the amount of perpetual preferred stock that may be included in a bank holding company's tier 1—both during and after the transition period—is, as described in section II(A), based solely upon a specified percentage of the organization's permanent core capital elements (that is, common equity, perpetual preferred stock, and minority interest in the equity of consolidated subsidiaries), not upon total tier 1 elements that temporarily include tier 2 items. Once the amount of supplementary items that may temporarily qualify as tier 1 elements is determined, goodwill must be deducted from the sum of this amount and the amount of the organization's permanent core capital elements for the purpose of calculating tier 1 (net of goodwill), tier 2, and total capital.

Attachment I—Sample Calculation of Risk-Based Capital Ratio for Bank Holding Companies

Example of a banking organization with $6,000 in total capital and the following assets and off-balance-sheet items:

Balance-sheet assets	
Cash	$ 5,000
U.S. Treasuries	20,000
Balances at domestic banks	5,000
Loans secured by first liens on 1- to 4-family residential properties	5,000
Loans to private corporations	65,000
Total Balance-Sheet Assets	$100,000

Off-balance-sheet items	
Standby letters of credit (SLCs) backing general-obligation debt issues of U.S. municipalities (GOs)	$ 10,000
Long-term legally binding commitments to private corporations	20,000
Total Off-Balance-Sheet Items	$ 30,000

This bank holding company's total capital to total assets (leverage ratio) would be:

($6,000/$100,000) = 6.00%.

To compute the bank holding company's weighted-risk assets:

1. Compute the credit-equivalent amount of each off-balance-sheet (OBS) item.

OBS item	*Face value*		*Conversion factor*		*Credit-equivalent amount*
SLCs backing municipal GOs	$10,000	×	1.00	=	$10,000
Long-term commitments to private corporations	$20,000	×	0.50	=	$10,000

Table continued

2. Multiply each balance-sheet asset and the credit-equivalent amount of each OBS item by the appropriate risk weight.

OBS item	*Face value*		*Conversion factor*		*Credit-equivalent amount*
0% category					
Cash	$ 5,000				
U.S. Treasuries	20,000				
	$25,000	×	0	=	0
20% category					
Balances at domestic banks	$ 5,000				
Credit-equivalent amounts of SLCs backing GOs of U.S. municipalities	10,000				
	$15,000	×	0.20	=	$ 3,000
50% category					
Loans secured by first liens on 1- to 4-family residential properties	$ 5,000	×	0.50	=	$ 2,500
100% category					
Loans to private corporations	$65,000				
Credit-equivalent amounts of long-term commitments to private corporations	10,000				
	$75,000	×	1.00	=	$75,000
Total Risk-Weighted Assets					$80,500

This bank holding company's ratio of total capital to weighted-risk assets (risk-based capital ratio) would be:

($6,000/$80,500) = 7.45%

Attachment II—Summary Definition of Qualifying Capital for Bank Holding Companies*

Using the Year-End 1992 Standards

Components	*Minimum requirements after transition period*
CORE CAPITAL (tier 1)	Must equal or exceed 4% of weighted-risk assets
Common stockholders' equity	No limit
Qualifying noncumulative perpetual preferred stock	No limit
Qualifying cumulative perpetual preferred stock	Limited to 25% of the sum of common stock, qualifying perpetual preferred stock, and minority interests
Minority interest in equity accounts of consolidated subsidiaries	Organizations should avoid using minority interests to introduce elements not otherwise qualifying for tier 1 capital
Less: Goodwill and other intangible assets required to be deducted from capital[1]	
SUPPLEMENTARY CAPITAL (tier 2)	Total of tier 2 is limited to 100% of tier 1[2]
Allowance for loan and lease losses	Limited to 1.25% of weighted-risk assets[2]
Perpetual preferred stock	No limit within tier 2
Hybrid capital instruments, perpetual debt, and mandatory convertible securities	No limit within tier 2
Subordinated debt and intermediate-term preferred stock (original weighted average maturity of 5 years or more)	Subordinated debt and intermediate-term preferred stock are limited to 50% of tier 1;[3] amortized for capital purposes as they approach maturity
Revaluation reserves (equity and building)	Not included; organizations encouraged to disclose; may be evaluated on a case-by-case basis for international comparisons; and taken into account in making an overall assessment of capital
DEDUCTIONS (from sum of tier 1 and tier 2)	
Investments in unconsolidated subsidiaries	As a general rule, one-half of the aggregate investments will be deducted from tier 1 capital and one-half from tier 2 capital[4]
Reciprocal holdings of banking organizations' capital securities	
Other deductions (such as other subsidiaries or joint ventures) as determined by supervisory authority	On a case-by-case basis or as a matter of policy after formal rulemaking
TOTAL CAPITAL (tier 1 + tier 2 − Deductions)	Must equal or exceed 8% of weighted-risk assets

[1] Requirements for the deduction of other intangible assets are set forth in section II.B.1.b. of this appendix.
[2] Amounts in excess of limitations are permitted but do not qualify as capital.
[3] Amounts in excess of limitations are permitted but do not qualify as capital.
[4] A proportionately greater amount may be deducted from tier 1 capital if the risks associated with the subsidiary so warrant.

* See discussion in section II of the guidelines for a complete description of the requirements for, and the limitations on, the components of qualifying capital.

Attachment III—Summary of Risk Weights and Risk Categories for Bank Holding Companies

Category 1: Zero Percent

1. Cash (domestic and foreign) held in subsidiary depository institutions or in transit

2. Balances due from Federal Reserve Banks (including Federal Reserve Bank stock) and central banks in other OECD countries

3. Direct claims on, and the portions of claims that are unconditionally guaranteed by, the U.S. Treasury and U.S. government agencies[1] and the central governments of other OECD countries, and local currency claims on, and the portions of local currency claims that are unconditionally guaranteed by, the central governments of non-OECD countries (including the central banks of non-OECD countries), to the extent that subsidiary depository institutions have liabilities booked in that currency

4. Gold bullion held in the vaults of a subsidiary depository institution or in another's vaults on an allocated basis, to the extent offset by gold bullion liabilities

5. Claims collateralized by cash on deposit in the subsidiary lending institution or by securities issued or guaranteed by OECD central governments or U.S. government agencies for which a positive margin of collateral is maintained on a daily basis, fully taking into account any change in the bank's exposure to the obligor or counterparty under a claim in relation to the market value of the collateral held in support of that claim

Category 2: 20 Percent

1. Cash items in the process of collection

2. All claims (long- or short-term) on, and the portions of claims (long- or short-term) that are guaranteed by, U.S. depository institutions and OECD banks

3. Short-term claims (remaining maturity of one year or less) on, and the portions of short-term claims that are guaranteed by, non-OECD banks

4. The portions of claims that are conditionally guaranteed by the central governments of OECD countries and U.S. government agencies, and the portions of local currency claims that are conditionally guaranteed by the central governments of non-OECD countries, to the extent that subsidiary depository institutions have liabilities booked in that currency

5. Claims on, and the portions of claims that are guaranteed by, U.S. government-sponsored agencies[2]

6. General obligation claims on, and the portions of claims that are guaranteed by the full faith and credit of, local governments and political subdivisions of the U.S. and other OECD local governments

7. Claims on, and the portions of claims that are guaranteed by, official multilateral lending institutions or regional development banks

8. The portions of claims that are collateralized[3] by cash on deposit in the subsidiary lending institution or by securities issued or guaranteed by the U.S. Treasury, the central governments of other OECD countries, and U.S. government agencies that do not qualify for the zero percent risk-weight category, or that are collateralized by securities issued or guaranteed by U.S. government–sponsored agencies.

9. The portions of claims that are collateralized[3] by securities issued by official multilateral lending institutions or regional development banks

10. Certain privately issued securities representing indirect ownership of mortgage-backed U.S. government agency or U.S. government–sponsored agency securities

[1] For the purpose of calculating the risk-based capital ratio, a U.S. government agency is defined as an instrumentality of the U.S. government whose obligations are fully and explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. government.

[2] For the purpose of calculating the risk-based capital ratio, a U.S. government–sponsored agency is defined as an agency originally established or chartered to serve public purposes specified by the U.S. Congress but whose obligations are not *explicitly* guaranteed by the full faith and credit of the U.S. government.

[3] The extent of collateralization is determined by current market value.

11. Investments in shares of a fund whose portfolio is permitted to hold only securities that would qualify for the zero or 20 percent risk categories

Category 3: 50 Percent

1. Loans fully secured by first liens on one- to four-family residential properties that have been made in accordance with prudent underwriting standards, that are performing in accordance with their original terms, and are not past due or in nonaccrual status, and certain privately issued mortgage-backed securities representing indirect ownership of such loans (Loans made for speculative purposes are excluded.)

2. Revenue bonds or similar claims that are obligations of U.S. state or local governments, or other OECD local governments, but for which the government entity is committed to repay the debt only out of revenues from the facilities financed

3. Credit-equivalent amounts of interest rate– and foreign exchange rate–related contracts, except for those assigned to a lower risk category

Category 4: 100 Percent

1. All other claims on private obligors

2. Claims on, or guaranteed by, non-OECD foreign banks with a remaining maturity exceeding one year

3. Claims on, or guaranteed by, non-OECD central governments that are not included in item 3 of category 1 or item 4 of category 2; all claims on non-OECD state or local governments

4. Obligations issued by U.S. state or local governments, or other OECD local governments (including industrial-development authorities and similar entities), repayable solely by a private party or enterprise

5. Premises, plant, and equipment; other fixed assets; and other real estate owned

6. Investments in any unconsolidated subsidiaries, joint ventures, or associated companies—if not deducted from capital

7. Instruments issued by other banking organizations that qualify as capital—if not deducted from capital

8. Claims on commercial firms owned by a government

9. All other assets, including any intangible assets that are not deducted from capital

Attachment IV—Credit-Conversion Factors for Off-Balance-Sheet Items for Bank Holding Companies

100 Percent Conversion Factor

1. Direct credit substitutes (These include general guarantees of indebtedness and all guarantee-type instruments, including standby letters of credit backing the financial obligations of other parties.)

2. Risk participations in banker's acceptances and direct credit substitutes, such as standby letters of credit

3. Sale and repurchase agreements and assets sold with recourse that are not included on the balance sheet

4. Forward agreements to purchase assets, including financing facilities, on which drawdown is certain

5. Securities lent for which the banking organization is at risk

50 Percent Conversion Factor

1. Transaction-related contingencies (These include bid bonds, performance bonds, warranties, and standby letters of credit backing the nonfinancial performance of other parties.)

2. Unused portions of commitments with an original maturity exceeding one year, including underwriting commitments and commercial credit lines

3. Revolving underwriting facilities (RUFs), note issuance facilities (NIFs), and similar arrangements

20 Percent Conversion Factor

Short-term, self-liquidating, trade-related contingences, including commercial letters of credit

Zero Percent Conversion Factor

Unused portions of commitments with an original maturity of one year or less, or which are unconditionally cancellable at any time, provided a separate credit decision is made before each drawing

Credit Conversion for Derivative Contracts

1. The credit-equivalent amount of a derivative contract is the sum of the current credit exposure of the contract and an estimate of potential future increases in credit exposure. The current exposure is the positive mark-to-market value of the contract (or zero if the mark-to-market value is zero or negative). For derivative contracts that are subject to a qualifying bilateral netting contract the current exposure is, generally, the net sum of the positive and negative mark-to-market values of the contracts included in the netting contract (or zero if the net sum of the mark-to-market values is zero or negative). The potential future exposure is calculated by multiplying the effective notional amount of a contract by one of the following credit conversion factors, as appropriate:

Conversion Factors
(in percent)

Remaining maturity	*Interest-rate*	*Exchange-rate and gold*	*Equity*	*Commodity, excluding precious metals*	*Precious metals, except gold*
One year or less	0.0	1.0	6.0	10.0	7.0
Over one to five years	0.5	5.0	8.0	12.0	7.0
Over five years	1.5	7.5	10.0	15.0	8.0

For contracts subject to a qualifying bilateral netting contract, the potential future exposure is, generally, the sum of the individual potential future exposures for each contract included under the netting contract adjusted by the application of the following formula:

$$A_{net} = (0.4 \times A_{gross}) + 0.6\ (NGR \times A_{gross})$$

NGR is the ratio of net current exposure to gross current exposure.

2. No potential future exposure is calculated for single-currency interest-rate swaps in which payments are made based upon two floating indices, that is, so-called floating/floating or basis swaps. The credit exposure on these contracts is evaluated solely on the basis of their mark-to-market value. Exchange-rate contracts with an original maturity of 14 or fewer days are excluded. Instruments traded on exchanges that require daily receipt and payment of cash variation margin are also excluded.

Attachment V—Calculating Credit-Equivalent Amounts for Derivative Contracts

Type of contract	*Notional principal amount*	*Conversion factor*	*Potential exposure (dollars)*	*Mark-to-market*	*Current exposure (dollars)*	*Credit-equivalent amount*
(1) 120-day forward foreign exchange	5,000,000	.01	50,000	100,000	100,000	150,000
(2) 4-year forward foreign exchange	6,000,000	.05	60,000	−120,000	-0-	300,000
(3) 3-year single-currency fixed and floating interest-rate swap	10,000,000	.005	50,000	200,000	200,000	250,000
(4) 6-month oil swap	10,000,000	.005	50,000	−250,000	-0-	1,000,000
(5) 7-year cross-currency floating and floating interest-rate swap	20,000,000	.075	1,000,000	−1,500,000	-0-	1,500,000
TOTAL			2,900,000	+	300,000	$3,200,000

a. If contracts (1) through (5) above are subject to a qualifying bilateral netting contract, then the following applies:

Contract	*Potential future exposure*		*Net current exposure*		*Credit-equivalent amount*
(1)	50,000				
(2)	300,000				
(3)	50,000				
(4)	1,000,000				
(5)	1,000,000				
TOTAL	2,900,000	+	0	=	2,900,000

NOTE: The total of the mark-to-market values from the first table is −1,370,000. Since this is a negative amount, the net current exposure is zero.

b. To recognize the effects of bilateral netting on potential future exposure the following formula applies:

$$A_{net} = (0.4 \times A_{gross}) + 0.6\ (NGR \times A_{gross})$$

c. In the above example, where the net current exposure is zero, the credit-equivalent amount would be calculated as follows:

$$NGR = 0 = (0/300{,}000)$$
$$A_{net} = (0.4 \times \$2{,}900{,}000) + .6\ (0 \times \$2{,}900{,}000)$$
$$A_{net} = \$1{,}160{,}000$$

The credit-equivalent amount is \$1,160,000 + 0 = \$1,160,000.

d. If the net current exposure was a positive number, for example \$200,000, the credit equivalent would be calculated as follows:

$$NGR = .67 = (\$200{,}000/\$300{,}000)$$
$$A_{net} = (0.4 \times \$2{,}900{,}000) + 0.6(.67 \times \$2{,}900{,}000)$$
$$A_{net} = \$2{,}325{,}800$$

The credit-equivalent amount would be \$2,325,800 + \$200,000 = \$2,525,800.

Attachment VI

SUMMARY OF:

	Transitional Arrangements for Bank Holding Companies		*Final Arrangement*
	Initial	*Year-end 1990*	*Year-end 1992*
1. Minimum standard of total capital to weighted-risk assets	None	7.25%	8.0%
2. Definition of tier 1 capital	Common equity, qualifying cumulative perpetual preferred stock,[1] and minority interests, plus supplementary elements,[2] less goodwill[3]	Common equity, qualifying cumulative and noncumulative perpetual preferred stock,[1] and minority interests, plus supplementary elements,[4] less goodwill[3]	Common equity, qualifying noncumulative and cumulative perpetual preferred stock,[1] and minority interest less goodwill and other intangible assets required to be deducted from capital[3]
3. Minimum standards of tier 1 capital to weighted-risk assets	None	3.625%	4.0%
4. Minimum standard of stockholders' equity to weighted-risk assets	None	3.25%	4.0%
5. Limitations on supplementary capital elements			
a. Allowance for loan and lease losses	No limit within tier 2	1.5% of weighted-risk assets	1.25% of weighted-risk assets
b. Perpetual preferred stock	No limit within tier 2	No limit within tier 2	No limit within tier 2
c. Hybrid capital instruments, perpetual debt, and mandatory convertibles	No limit within tier 2	No limit within tier 2	No limit within tier 2
d. Subordinated debt and intermediate-term preferred stock	Combined maximum of 50% of tier 1	Combined maximum of 50% of tier 1	Combined maximum of 50% of tier 1
e. Total qualifying tier 2 capital	May not exceed tier 1 capital	May not exceed tier 1 capital	May not exceed tier 1 capital
6. Definition of total capital	Tier 1 *plus* tier 2 *less*: • reciprocal holdings of banking organizations' capital instruments • investments in unconsolidated subsidiaries[5]	Tier 1 *plus* tier 2 *less*: • reciprocal holdings of banking organizations' capital instruments • investments in unconsolidated subsidiaries[5]	Tier 1 *plus* tier 2 *less*: • reciprocal holdings of banking organizations' capital instruments • investments in unconsolidated subsidiaries[5]

[1] Cumulative perpetual preferred stock is limited within tier 1 to 25% of the sum of common stockholders' equity, qualifying perpetual preferred stock, and minority interest.

[2] Supplementary elements may be included in tier 1 up to 25% of the sum of tier 1 plus goodwill.

[3] Requirements for the deduction of other intangible assets are set forth in section II.B.1.b of this appendix.

[4] Supplementary elements may be included in tier 1 up to 10% of the sum of tier 1 plus goodwill.

[5] As a general rule, one-half (50%) of the aggregate amount of investments will be deducted from tier 1 capital and one-half (50%) from tier 2 capital. A proportionally greater amount may be deducted from tier 1 capital if the risks associated with the subsidiary so warrant.

Capital Adequacy Guidelines for Bank Holding Companies and State Member Banks: Leverage Measure

12 CFR 225, appendix B; as amended effective September 1, 1995

The Board of Governors of the Federal Reserve System has adopted minimum capital ratios and guidelines to provide a framework for assessing the adequacy of the capital of bank holding companies and state member banks (collectively "banking organizations"). The guidelines generally apply to all state member banks and bank holding companies regardless of size and are to be used in the examination and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. The Board of Governors will review the guidelines from time to time for possible adjustments commensurate with changes in the economy, financial markets, and banking practices. In this regard, the Board has determined that during the transition period through year-end 1990 for implementation of the risk-based capital guidelines contained in appendix A to this part and in appendix A to part 208 a banking organization may choose to fulfill the requirements of the guidelines relating capital to total assets contained in this appendix in one of two manners. Until year-end 1990, a banking organization may choose to conform to either the 5.5 percent and 6 percent minimum primary and total capital standards set forth in this appendix, or the 7.25 percent year-end 1990 minimum risk-based capital standard set forth in appendix A to this part and appendix A to part 208. Those organizations that choose to conform during this period to the 7.25 percent year-end 1990 risk-based capital standard will be deemed to be in compliance with the capital adequacy guidelines set forth in this appendix.

Two principal measurements of capital are used—the primary capital ratio and the total capital ratio. The definitions of primary and total capital for banks and bank holding companies and formulas for calculating the capital ratios are set forth below in the definitional sections of these guidelines.

Capital Guidelines

The Board has established a minimum level of primary capital to total assets of 5.5 percent and a minimum level of total capital to total assets of 6.0 percent. Generally, banking organizations are expected to operate above the minimum primary and total capital levels. Those organizations whose operations involve or are exposed to high or inordinate degrees of risk will be expected to hold additional capital to compensate for these risks.

In addition, the Board has established the following three zones for total capital for banking organizations of all sizes:

	Total Capital Ratio
Zone 1	Above 7.0%
Zone 2	6.0% to 7.0%
Zone 3	Below 6.0%

The capital guidelines assume adequate liquidity and a moderate amount of risk in the loan and investment portfolios and in off-balance-sheet activities. The Board is concerned that some banking organizations may attempt to comply with the guidelines in ways that reduce their liquidity or increase risk. Banking organizations should avoid the practice of attempting to meet the guidelines by decreasing the level of liquid assets in relation to total assets. In assessing compliance with the guidelines, the Federal Reserve will take into account liquidity and the overall degree of risk associated with an organization's operations, including the volume of assets exposed to risk.

The Federal Reserve will also take into account the sale of loans or other assets with recourse and the volume and nature of all off-balance-sheet risk. Particularly close attention will be directed to risks associated with standby letters of credit and participation in joint-venture activities. The Federal Reserve will review the relationship of all on- and off-balance-sheet risks to capital and will require those institutions with high or inordinate levels of risk to hold additional primary capital. In addition, the Federal Reserve will continue to review the need for more explicit procedures for factoring on- and off-balance-sheet risks into the assessment of capital adequacy.

The capital guidelines apply to both banks and bank holding companies on a consolidated basis.[1] Some banking organizations are engaged in significant nonbanking activities that typically require capital ratios higher than those of commercial banks alone. The Board believes that, as a matter of both safety and soundness and competitive equity, the degree of leverage common in banking should not automatically extend to nonbanking activities. Consequently, in evaluating the consolidated capital positions of banking organizations, the Board is placing greater weight on the building-block approach for assessing capital requirements. This approach generally provides that nonbank subsidiaries of a banking organization should maintain levels of capital consistent with the levels that have been established by industry norms or standards, by federal or state regulatory agencies for similar firms that are not affiliated with banking organizations, or that may be established by the Board after taking into account risk factors of a particular industry. The assessment of an organization's consolidated capital adequacy must take into account the amount and nature of all nonbank activities, and an institution's consolidated capital position should at least equal the sum of the capital requirements of the organization's bank and nonbank subsidiaries as well as those of the parent company.

Supervisory Action

The nature and intensity of supervisory action will be determined by an organization's compliance with the required minimum primary capital ratio as well as by the zone in which the company's total capital ratio falls. Banks and bank holding companies with primary capital ratios below the 5.5 percent minimum will be considered undercapitalized unless they can demonstrate clear extenuating circumstances. Such banking organizations will be required to submit an acceptable plan for achieving compliance with the capital guidelines and will be subject to denial of applications and appropriate supervisory enforcement actions.

The zone into which an organization's total capital ratio falls will normally trigger the following supervisory responses, subject to qualitative analysis:

- For institutions operating in zone 1, the Federal Reserve will consider that capital is generally adequate if the primary capital ratio is acceptable to the Federal Reserve and is above the 5.5 percent minimum.
- For institutions operating in zone 2, the Federal Reserve will pay particular attention to financial factors, such as asset quality, liquidity, off-balance-sheet risk, and interest-rate risk, as they relate to the adequacy of capital. If these areas are deficient and the Federal Reserve concludes capital is not fully adequate, the Federal Reserve will intensify its monitoring and take appropriate supervisory action.
- For institutions operating in zone 3, the Federal Reserve will—
  —consider that the institution is undercapitalized, absent clear extenuating circumstances;
  —require the institution to submit a comprehensive capital plan, acceptable to the Federal Reserve, that includes a program for achieving compliance with the required minimum ratios within a reasonable time period; and
  —institute appropriate supervisory and/or administrative enforcement action, which may include the issuance of a capital directive or denial of applications, unless a capital plan acceptable to the Federal Reserve has been adopted by the institution.

Treatment of Intangible Assets for Purpose of Assessing Capital Adequacy

In considering the treatment of intangible assets for the purpose of assessing capital adequacy, the Federal Reserve recognizes that

[1] The guidelines will apply to bank holding companies with less than $150 million in consolidated assets on a bank-only basis unless (1) the holding company or any nonbank subsidiary is engaged directly or indirectly in any nonbank activity involving significant leverage or (2) the holding company or any nonbank subsidiary has outstanding significant debt held by the general public. Debt held by the general public is defined to mean debt held by parties other than financial institutions, officers, directors, and controlling shareholders of the banking organization or their related interests.

the determination of the future benefits and useful lives of certain intangible assets may involve a degree of uncertainty that is not normally associated with other banking assets. Supervisory concern over intangible assets derives from this uncertainty and from the possibility that, in the event an organization experiences financial difficulties, such assets may not provide the degree of support generally associated with other assets. For this reason, the Federal Reserve will carefully review the level and specific character of intangible assets in evaluating the capital adequacy of state member banks and bank holding companies.

The Federal Reserve recognizes that intangible assets may differ with respect to predictability of any income stream directly associated with a particular asset, the existence of a market for the asset, the ability to sell the asset, or the reliability of any estimate of the asset's useful life. Certain intangible assets have predictable income streams and objectively verifiable values and may contribute to an organization's profitability and overall financial strength. The value of other intangibles, such as goodwill, may involve a number of assumptions and may be more subject to changes in general economic circumstances or to changes in an individual institution's future prospects. Consequently, the value of such intangible assets may be difficult to ascertain. Consistent with prudent banking practices and the principle of the diversification of risks, banking organizations should avoid excessive balance-sheet concentration in any category or related categories of intangible assets.

Bank Holding Companies

While the Federal Reserve will consider the amount and nature of all intangible assets, those holding companies with aggregate intangible assets in excess of 25 percent of tangible primary capital (i.e., stated primary capital less all intangible assets) or those institutions with lesser, although still significant, amounts of goodwill will be subject to close scrutiny. For the purpose of assessing capital adequacy, the Federal Reserve may, on a case-by-case basis, make adjustments to an organization's capital ratios based upon the amount of intangible assets in excess of the 25 percent threshold level or upon the specific character of the organization's intangible assets in relation to its overall financial condition. Such adjustments may require some organizations to raise additional capital.

The Board expects banking organizations (including state member banks) contemplating expansion proposals to ensure that pro forma capital ratios exceed the minimum capital levels without significant reliance on intangibles, particularly goodwill. Consequently, in reviewing acquisition proposals, the Board will take into consideration both the stated primary capital ratio (that is, the ratio without any adjustment for intangible assets) and the primary capital ratio after deducting intangibles. In acting on applications, the Board will take into account the nature and amount of intangible assets and will, as appropriate, adjust capital ratios to include certain intangible assets on a case-by-case basis.

State Member Banks

State member banks with intangible assets in excess of 25 percent of tangible primary capital will be subject to close scrutiny. In addition, for the purpose of calculating capital ratios of state member banks, the Federal Reserve will deduct goodwill from primary capital and total capital. The Federal Reserve may, on a case-by-case basis, make further adjustments to a bank's capital ratios based on the amount of intangible assets (aside from goodwill) in excess of the 25 percent threshold level or on the specific character of the bank's intangible assets in relation to its overall financial condition. Such adjustments may require some banks to raise additional capital.

In addition, state member banks and bank holding companies are expected to review periodically the value at which intangible assets are carried on their balance sheets to determine whether there has been any impairment of value or whether changing circumstances warrant a shortening of amortization periods. Institutions should make appropriate reductions in carrying values and amortization periods in light of this review, and examiners will evaluate the treatment of intangible assets during on-site examinations.

Definition of Capital to Be Used in Determining Capital Adequacy

Primary Capital Components

The components of primary capital are—

- common stock,
- perpetual preferred stock (preferred stock that does not have a stated maturity date and that may not be redeemed at the option of the holder),
- surplus (excluding surplus relating to limited-life preferred stock),
- undivided profits,
- contingency and other capital reserves,
- mandatory convertible instruments,[2]
- allowance for possible loan and lease losses (exclusive of allocated transfer risk reserves),
- minority interest in equity accounts of consolidated subsidiaries, and
- perpetual debt instruments (for bank holding companies but not for state member banks).

Limits on Certain Forms of Primary Capital

Bank holding companies. The maximum composite amount of mandatory convertible securities, perpetual debt, and perpetual preferred stock that may be counted as primary capital for bank holding companies is limited to 33.3 percent of all primary capital, including these instruments. Perpetual preferred stock issued prior to November 20, 1985, (or determined by the Federal Reserve to be in the process of being issued prior to that date) shall continue to be included as primary capital.

The maximum composite amount of mandatory convertible securities and perpetual debt that may be counted as primary capital for bank holding companies is limited to 20 percent of all primary capital, including these instruments. The maximum amount of equity commitment notes (a form of mandatory convertible securities) that may be counted as primary capital for a bank holding company is limited to 10 percent of all primary capital, including mandatory convertible securities. Amounts outstanding in excess of these limitations may be counted as secondary capital provided they meet the requirements of secondary capital instruments.

State member banks. The composite limitations on the amount of mandatory convertible securities and perpetual preferred stock (perpetual debt is not primary capital for state member banks) that may serve as primary capital for bank holding companies shall not be applied formally to state member banks, although the Board shall determine appropriate limits for these forms of primary capital on a case-by-case basis.

The maximum amount of mandatory convertible securities that may be counted as primary capital for state member banks is limited to 16⅔ percent of all primary capital, including mandatory convertible securities. Equity commitment notes, one form of mandatory convertible securities, shall not be included as primary capital for state member banks except that notes issued by state member banks prior to May 15, 1985, will continue to be included in primary capital. Amounts of mandatory convertible securities in excess of these limitations may be counted as secondary capital if they meet the requirements of secondary capital instruments.

Secondary Capital Components

The components of secondary capital are—

- limited-life preferred stock (including related surplus) and
- bank subordinated notes and debentures and unsecured long-term debt of the parent company and its nonbank subsidiaries.

Restrictions Relating to Capital Components

To qualify as primary or secondary capital, a capital instrument should not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices. Examples of such terms are those regarded as unduly interfering with the ability of the bank or holding company to conduct normal banking operations or those resulting in significantly higher dividends or interest payments in the event of a deterioration in the financial condition of the issuer.

[2] See the definitional section below that lists the criteria for mandatory convertible instruments to qualify as primary capital.

The secondary components must meet the following conditions to qualify as capital:

- The instrument must have an original weighted-average maturity of at least seven years.
- The instrument must be unsecured.
- The instrument must clearly state on its face that it is not a deposit and is not insured by a federal agency.
- Bank debt instruments must be subordinated to claims of depositors.
- For banks only, the aggregate amount of limited-life preferred stock and subordinate debt qualifying as capital may not exceed 50 percent of the amount of the bank's primary capital.

As secondary capital components approach maturity, the banking organization must plan to redeem or replace the instruments while maintaining an adequate overall capital position. Thus, the remaining maturity of secondary capital components will be an important consideration in assessing the adequacy of total capital.

Capital Ratios

The primary and total capital ratios for bank holding companies are computed as follows:

Primary capital ratio:

$$\frac{\text{Primary capital components}}{\text{Total assets + Allowance for loan and lease losses (exclusive of allocated transfer risk reserves)}}$$

Total capital ratio:

$$\frac{\text{Primary capital components + Secondary capital components}}{\text{Total assets + Allowance for loan and lease losses (exclusive of allocated transfer risk reserves)}}$$

The primary and total capital ratios for state member banks are computed as follows:

Primary capital ratio:

$$\frac{\text{Primary capital components–Goodwill}}{\text{Average total assets + Allowance for loan and lease losses (exclusive of allocated transfer risk reserves)–Goodwill}}$$

Total capital ratio:

$$\frac{\text{Primary capital components + Secondary capital components–Goodwill}}{\text{Average total assets + Allowance for loan and lease losses (exclusive of allocated transfer risk reserves)–Goodwill}}$$

Generally, period-end amounts will be used to calculate bank holding company ratios. However, the Federal Reserve will discourage temporary balance-sheet adjustments or any other "window dressing" practices designed to achieve transitory compliance with the guidelines. Banking organizations are expected to maintain adequate capital positions at all times. Thus, the Federal Reserve will, on a case-by-case basis, use average total assets in the calculation of bank holding company capital ratios whenever this approach provides a more meaningful indication of an individual holding company's capital position.

For the calculation of bank capital ratios, "average total assets" will generally be defined as the quarterly average total assets figure reported on the bank's Report of Condition. If warranted, however, the Federal Reserve may calculate bank capital ratios based upon total assets as of period-end. All other components of the bank's capital ratios will be based upon period-end balances.

Criteria for Determining Primary Capital Status of Mandatory Convertible Securities

Mandatory convertible securities are subordinated debt instruments that are eventually transformed into common or perpetual preferred stock within a specified period of time, not to exceed 12 years. To be counted as primary capital, mandatory convertible securities must meet the criteria set forth below. These criteria cover the two basic types of mandatory convertible securities: equity contract notes (securities that obligate the holder to take common or perpetual preferred stock of the issuer in lieu of cash for repayment of principal) and equity commitment notes (securities that are redeemable only with the proceeds from the sale of common or perpetual preferred stock). Both equity commitment notes and equity contract notes qualify as primary capital for bank holding companies, but only equity contract notes qualify as primary capital for banks.

Criteria Applicable to Both Types of Mandatory Convertible Securities

a. The securities must mature in 12 years or less.

b. The issuer may redeem securities prior to maturity only with the proceeds from the sale of common or perpetual preferred stock of the bank or bank holding company. Any exception to this rule must be approved by the Federal Reserve. The securities may not be redeemed with the proceeds of another issue of mandatory convertible securities. Nor may the issuer repurchase or acquire its own mandatory convertible securities for resale or reissuance.

c. Holders of the securities may not accelerate the payment of principal except in the event of bankruptcy, insolvency, or reorganization.

d. The securities must be subordinate in right of payment to all senior indebtedness of the issuer. In the event that the proceeds of the securities are reloaned to an affiliate, the loan must be subordinated to the same degree as the original issue.

e. An issuer that intends to dedicate the proceeds of an issue of common or perpetual preferred stock to satisfy the funding requirements of an issue of mandatory convertible securities (i.e. the requirement to retire or redeem the notes with the proceeds from the issuance of common or perpetual preferred stock) generally must make such a dedication during the quarter in which the new common or preferred stock is issued.[3] As a general rule, if the dedication is not made within the prescribed period, then the securities issued may not at a later date be dedicated to the retirement or redemption of the mandatory convertible securities.[4]

Additional Criteria Applicable to Equity Contract Notes

a. The note must contain a contractual provision (or must be issued with a mandatory stock purchase contract) that requires the holder of the instrument to take the common or perpetual stock of the issuer in lieu of cash in satisfaction of the claim for principal repayment. The obligation of the holder to take the common or perpetual preferred stock of the issuer may be waived if, and to the extent that, prior to the maturity date of the obligation, the issuer sells new common or perpetual preferred stock and dedicates the proceeds to the retirement or redemption of the notes. The dedication generally must be made during the quarter in which the new common or preferred stock is issued.

b. A stock purchase contract may be separated from a security only if (1) the holder of the contract provides sufficient collateral[5] to the issuer, or to an independent trustee for the benefit of the issuer, to ensure performance under the contract and (2) the stock purchase contract requires the purchase of common or perpetual preferred stock.

Additional Criteria Applicable to Equity Commitment Notes

a. The indenture or note agreement must contain the following two provisions:

1. The proceeds of the sale of common or perpetual preferred stock will be the sole source of repayment for the notes, and the

[3] Common or perpetual preferred stock issued under dividend reinvestment plans or issued to finance acquisitions, including acquisitions of business entities, may be dedicated to the retirement or redemption of the mandatory convertible securities. Documentation certified by an authorized agent of the issuer showing the amount of common stock or perpetual preferred stock issued, the dates of issue, and amounts of such issues dedicated to the retirement or redemption of mandatory convertible securities will satisfy the dedication requirement.

[4] The dedication procedure is necessary to ensure that the primary capital of the issuer is not overstated. For each dollar of common or perpetual preferred proceeds dedicated to the retirement or redemption of the notes, there is a corresponding reduction in the amount of outstanding mandatory securities that may qualify as primary capital. De minimis amounts (in relation to primary capital) of common or perpetual preferred stock issued under arrangements in which the amount of stock issued is not predictable, such as dividend reinvestment plans and employee stock option plans (but excluding public stock offerings and stock issued in connection with acquisitions), should be dedicated by no later than the company's fiscal year-end.

[5] Collateral is defined as (1) cash or certificates of deposit; (2) U.S. government securities that will mature prior to or simultaneous with the maturity of the equity contract and that have a par or maturity value at least equal to the amount of the holder's obligation under the stock purchase contract; (3) standby letters of credit issued by an insured U.S. bank that is not an affiliate of the issuer; or (4) other collateral as may be designated from time to time by the Federal Reserve.

issuer must dedicate the proceeds for the purpose of repaying the notes. (Documentation certified by an authorized agent of the issuer showing the amount of common or perpetual preferred stock issued, the dates of issue, and amounts of such issues dedicated to the retirement or redemption of mandatory convertible securities will satisfy the dedication requirement.)

2. By the time that one-third of the life of the securities has run, the issuer must have raised and dedicated an amount equal to one-third of the original principal of the securities. By the time that two-thirds of the life of the securities has run, the issuer must have raised and dedicated an amount equal to two-thirds of the original principal of the securities. At least 60 days prior to the maturity of the securities, the issuer must have raised and dedicated an amount equal to the entire original principal of the securities. Proceeds dedicated to redemption or retirement of the notes must come only from the sale of common or perpetual preferred stock.[6]

b. If the issuer fails to meet any of these periodic funding requirements, the Federal Reserve immediately will cease to treat the unfunded securities as primary capital and will take appropriate supervisory action. In addition, failure to meet the funding requirements will be viewed as a breach of a regulatory commitment and will be taken into consideration by the Board in acting on statutory applications.

c. If a security is issued by a subsidiary of a bank or bank holding company, any guarantee of the principal by that subsidiary's parent bank or bank holding company must be subordinate to the same degree as the security issued by the subsidiary and limited to repayment of the principal amount of the security at its final maturity.

Criteria for Determining the Primary Capital Status of Perpetual Debt Instruments of Bank Holding Companies

a. The instrument must be unsecured and, if issued by a bank, must be subordinated to the claims of depositors.

b. The instrument may not provide the noteholder with the right to demand repayment of principal except in the event of bankruptcy, insolvency, or reorganization. The instrument must provide that nonpayment of interest shall not trigger repayment of the principal of the perpetual debt note or any other obligation of the issuer, nor shall it constitute prima facie evidence of insolvency or bankruptcy.

c. The issuer shall not voluntarily redeem the debt issue without prior approval of the Federal Reserve, except when the debt is converted to, exchanged for, or simultaneously replaced in like amount by an issue of common or perpetual preferred stock of the issuer or the issuer's parent company.

d. If issued by a bank holding company, a bank subsidiary, or a subsidiary with substantial operations, the instrument must contain a provision that allows the issuer to defer interest payments on the perpetual debt in the event of, and at the same time as the elimination of dividends on all outstanding common or preferred stock of the isssuer (or in the case of a guarantee by a parent company at the same time as the elimination of the dividends of the parent company's common and preferred stock). In the case of a nonoperating subsidiary (a funding subsidiary or one formed to issue securities), the deferral of interest payments must be triggered by elimination of dividends by the parent company.

e. If issued by a bank holding company or a subsidiary with substantial operations, the instrument must convert automatically to common or perpetual preferred stock of the issuer when the issuer's retained earnings and surplus accounts become negative. If an operating subsidiary's perpetual debt is guaranteed by its parent, the debt may convert to the shares of the issuer or guarantor and such conversion may be triggered when the issuer's or parent's retained earnings and surplus accounts become negative. If issued by a nonoperating subsidiary of a bank holding company or bank, the instrument must convert

[6] The funded portions of the securities will be deducted from primary capital to avoid double-counting.

automatically to common or preferrred stock of the issuer's parent when the retained earnings and surplus accounts of the issuer's parent become negative.

Capital Adequacy Guidelines for State Member Banks: Tier 1 Leverage Measure

12 CFR 208, appendix B; as amended effective August 1, 1995

I. Overview

a. The Board of Governors of the Federal Reserve System has adopted a minimum ratio of tier 1 capital to total assets to assist in the assessment of the capital adequacy of state member banks.[1] The principal objective of this measure is to place a constraint on the maximum degree to which a state member bank can leverage its equity capital base. It is intended to be used as a supplement to the risk-based capital measure.

b. The guidelines apply to all state member banks on a consolidated basis and are to be used in the examination and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. The Board will review the guidelines from time to time and will consider the need for possible adjustments in light of any significant changes in the economy, financial markets, and banking practices.

II. The Tier 1 Leverage Ratio

a. The Board has established a *minimum* level of tier 1 capital to total assets of 3 percent. An institution operating at or near these levels is expected to have well-diversified risk, including no undue interest-rate risk exposure; excellent asset quality; high liquidity; and good earnings; and in general be considered a strong banking organization, rated composite 1 under the CAMEL rating system of banks. Institutions not meeting these characteristics, as well as institutions with supervisory, financial, or operational weaknesses, are expected to operate well above minimum capital standards. Institutions experiencing or anticipating significant growth also are expected to maintain capital ratios, including tangible capital positions, well above the minimum levels. For example, most such banks generally have operated at capital levels ranging from 100 to 200 basis points above the stated minimums. Higher capital ratios could be required if warranted by the particular circumstances or risk profiles of individual banks. Thus, for all but the most highly rated banks meeting the conditions set forth above, the minimum tier 1 leverage ratio is to be 3 percent plus an additional cushion of at least 100 to 200 basis points. In all cases, banking institutions should hold capital commensurate with the level and nature of all risks, including the volume and severity of problem loans, to which they are exposed.

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 for year-end 1992 as set forth in the risk-based capital guidelines contained in appendix A of this part will be used.[2] As a general matter, average total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the bank's Reports of Condition and Income (call report), less goodwill; amounts of mortgage-servicing rights and purchased credit-card relationships that, in the aggregate, are in excess of 50 percent of tier 1 capital; amounts of purchased credit-card relationships in excess of 25 percent of tier 1 capital; all other intangible assets; any investments in subsidiaries or associated companies that the Federal Reserve determines should be de-

[1] Supervisory risk-based capital ratios that relate capital to weighted-risk assets for state member banks are outlined in appendix A to this part.

[2] At the end of 1992, 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 excludes goodwill; amounts of mortgage-servicing rights and purchased credit-card relationships that, in the aggregate, exceed 50 percent of tier 1 capital; amounts of purchased credit-card relationships that exceed 25 percent of tier 1 capital; all other 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.

ducted 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 this appendix A.[3]

c. Notwithstanding other provisions of this appendix B, a qualifying bank that has transferred small-business loans and leases on personal property (small-business obligations) with recourse shall, for purposes of calculating its tier 1 leverage ratio, exclude from its average total consolidated assets the outstanding principal amount of the small-business loans and leases transferred with recourse, provided two conditions are met. First, the transaction must be treated as a sale under generally accepted accounting principles (GAAP) and, second, the bank must establish pursuant to GAAP a noncapital reserve sufficient to meet the bank's reasonably estimated liability under the recourse arrangement. Only loans and leases to businesses that meet the criteria for a small-business concern established by the Small Business Administration under section 3(a) of the Small Business Act are eligible for this capital treatment.

d. For purposes of this appendix B, a bank is qualifying if it meets the criteria set forth in the Board's prompt-corrective-action regulation (12 CFR 208.30) for well capitalized or, by order of the Board, adequately capitalized. For purposes of determining whether a bank meets these criteria, its capital ratios must be calculated without regard to the preferential capital treatment for transfers of small-business obligations with recourse specified in section II.c. of this appendix B. The total outstanding amount of recourse retained by a qualifying bank on transfers of small-business obligations receiving the preferential capital treatment cannot exceed 15 percent of the bank's total risk-based capital. By order, the Board may approve a higher limit.

[3] Deductions from tier 1 capital and other adjustments are discussed more fully in section II.B. of appendix A to this part.

e. If a bank ceases to be qualifying or exceeds the 15 percent capital limitation, the preferential capital treatment will continue to apply to any transfers of small-business obligations with recourse that were consummated during the time that the bank was qualifying and did not exceed the capital limit.

f. The leverage capital ratio of the bank shall be calculated without regard to the preferential capital treatment for transfers of small-business obligations with recourse specified in section II of this appendix B for purposes of—

i. determining whether a bank is adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized under prompt corrective action (12 CFR 208.33(b)); and
ii. reclassifying a well-capitalized bank to adequately capitalized and requiring an adequately capitalized bank to comply with certain mandatory or discretionary supervisory actions as if the bank were in the next lower prompt-corrective-action capital category (12 CFR 208.33(c)).

g. Whenever appropriate, including when a bank is undertaking expansion, seeking to engage in new activities, or otherwise facing unusual or abnormal risks, the Board will continue to consider the level of an individual bank's tangible tier 1 leverage ratio (after deducting all intangibles) in making an overall assessment of capital adequacy. This is consistent with the Federal Reserve's risk-based capital guidelines and long-standing Board policy and practice with regard to leverage guidelines. Banks experiencing growth, whether internally or by acquisition, are expected to maintain strong capital positions substantially above minimum supervisory levels, without significant reliance on intangible assets.

Capital Adequacy Guidelines for Bank Holding Companies: Tier 1 Leverage Measure

12 CFR 225, appendix D; as amended effective August 1, 1995

I. Overview

a. The Board of Governors of the Federal Reserve System has adopted a minimum ratio of tier 1 capital to total assets to assist in the assessment of the capital adequacy of bank holding companies ("banking organizations").[1] The principal objective of this measure is to place a constraint on the maximum degree to which a banking organization can leverage its equity capital base. It is intended to be used as a supplement to the risk-based capital measure.

b. The guidelines apply on a consolidated basis to bank holding companies with consolidated assets of $150 million or more. For bank holding companies with less than $150 million in consolidated assets, the guidelines will be applied on a bank-only basis unless (i) the parent bank holding company is engaged in nonbank activity involving significant leverage;[2] or (ii) the parent company has a significant amount of outstanding debt that is held by the general public.

c. The tier 1 leverage guidelines are to be used in the inspection and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. The Board will review the guidelines from time to time and will consider the need for possible adjustments in light of any significant changes in the economy, financial markets, and banking practices.

II. The Tier 1 Leverage Ratio

a. The Board has established a *minimum* level of tier 1 capital to total assets of 3 percent. A banking organization operating at or near these levels is expected to have well-diversified risk, including no undue interest-rate risk exposure; excellent asset quality; high liquidity; and good earnings; and in general be considered a strong banking organization, rated composite 1 under the BOPEC rating system for bank holding companies. Organizations not meeting these characteristics, as well as institutions with supervisory, financial, or operational weaknesses, are expected to operate well above minimum capital standards. Organizations experiencing or anticipating significant growth also are expected to maintain capital ratios, including tangible capital positions, well above the minimum levels. For example, most such organizations generally have operated at capital levels ranging from 100 to 200 basis points above the stated minimums. Higher capital ratios could be required if warranted by the particular circumstances or risk profiles of individual banking organizations. Thus, for all but the most highly rated organizations meeting the conditions set forth above, the minimum tier 1 leverage ratio is to be 3 percent plus an additional cushion of at least 100 to 200 basis points. In all cases, banking organizations should hold capital commensurate with the level and nature of all risks, including the volume and severity of problem loans, to which they are exposed.

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 for year-end 1992 as set forth in the risk-based capital guidelines contained in appendix A of this part will be used.[3] As a

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[1] Supervisory ratios that related capital to total assets for bank holding companies are outlined in appendix B of this part.

[2] A parent company that is engaged in significant off-balance-sheet activities would generally be deemed to be engaged in activities that involve significant leverage.

[3] At the end of 1992, 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 rights and purchased credit-card relationships that, in the aggregate, exceed 50 percent of tier 1 capital; amounts of purchased credit-card relationships that exceed 25 percent of tier 1 capital; all

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general matter, 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 organization's Consolidated Financial Statements (FR Y-9C Report), less goodwill; amounts of mortgage-servicing rights and purchased credit-card relationships that, in the aggregate, are in excess of 50 percent of tier 1 capital; amounts of purchased credit-card relationships in excess of 25 percent of tier 1 capital; all other intangible assets; 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 this appendix A.[4]

c. Whenever appropriate, including when an organization is undertaking expansion, seeking to engage in new activities, or otherwise facing unusual or abnormal risks, the Board will continue to consider the level of an individual organization's tangible tier 1 leverage ratio (after deducting all intangibles) in making an overall assessment of capital adequacy. This is consistent with the Federal Reserve's risk-based capital guidelines and long-standing Board policy and practice with regard to leverage guidelines. Organizations experiencing growth, whether internally or by acquisition, are expected to maintain strong capital positions substantially above minimum supervisory levels, without significant reliance on intangible assets.

Continued

other 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.

[4] Deductions from tier 1 capital and other adjustments are discussed more fully in section II.B. in appendix A of this part.

Capital Adequacy Guidelines for State Member Banks: Market-Risk Measure

12 CFR 208, appendix E; effective January 1, 1997

SECTION 1—Purpose, Applicability, Scope, and Effective Date

(a) *Purpose.* The purpose of this appendix is to ensure that banks with significant exposure to market risk maintain adequate capital to support that exposure.[1] This appendix supplements and adjusts the risk-based capital ratio calculations under appendix A of this part with respect to those banks.

(b) *Applicability.*

(1) This appendix applies to any insured state member bank whose trading activity[2] (on a worldwide consolidated basis) equals—

(i) 10 percent or more of total assets;[3] or

(ii) $1 billion or more.

(2) The Federal Reserve may additionally apply this appendix to any insured state member bank if the Federal Reserve deems it necessary or appropriate for safe and sound banking practices.

(3) The Federal Reserve may exclude an insured state member bank otherwise meeting the criteria of paragraph (b)(1) of this section from coverage under this appendix if it determines the bank meets such criteria as a consequence of accounting, operational, or similar considerations, and the Federal Reserve deems it consistent with safe and sound banking practices.

(c) *Scope.* The capital requirements of this appendix support market risk associated with a bank's covered positions.

(d) *Effective date.* This appendix is effective as of January 1, 1997. Compliance is not mandatory until January 1, 1998. Subject to supervisory approval, a bank may opt to comply with this appendix as early as January 1, 1997.[4]

SECTION 2—Definitions

For purposes of this appendix, the following definitions apply:

(a) *Covered positions* means all positions in a bank's trading account, and all foreign-exchange[5] and commodity positions, whether or not in the trading account.[6] Positions include on-balance-sheet assets and liabilities and off-balance-sheet items. Securities subject to repurchase and lending agreements are included as if they are still owned by the lender.

(b) *Market risk* means the risk of loss resulting from movements in market prices. Market risk consists of general market risk and specific risk components.

(1) *General market risk* means changes in the market value of covered positions resulting from broad market movements, such as changes in the general level of interest

[1] This appendix is based on a framework developed jointly by supervisory authorities from the countries represented on the Basle Committee on Banking Supervision and endorsed by the Group of Ten Central Bank Governors. The framework is described in a Basle Committee paper entitled "Amendment to the Capital Accord to Incorporate Market Risk," January 1996.

[2] "Trading activity" means the gross sum of trading assets and liabilities as reported in the bank's most recent quarterly Consolidated Report of Condition and Income (call report).

[3] "Total assets" means quarter-end total assets as reported in the bank's most recent call report.

[4] A bank that voluntarily complies with the final rule prior to January 1, 1998, must comply with all of its provisions.

[5] Subject to supervisory review, a bank may exclude structural positions in foreign currencies from its covered positions.

[6] The term trading account is defined in the instructions to the call report.

rates, equity prices, foreign-exchange rates, or commodity prices.

(2) *Specific risk* means changes in the market value of specific positions due to factors other than broad market movements and includes such risk as the credit risk of an instrument's issuer.

(c) *Tier 1* and *tier 2 capital* are defined in appendix A of this part.

(d) *Tier 3 capital* is subordinated debt that is unsecured; is fully paid up; has an original maturity of at least two years; is not redeemable before maturity without prior approval by the Federal Reserve; includes a lock-in clause precluding payment of either interest or principal (even at maturity) if the payment would cause the issuing bank's risk-based capital ratio to fall or remain below the minimum required under appendix A of this part; and does not contain and is not covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices.

(e) *Value-at-risk (VAR)* means the estimate of the maximum amount that the value of covered positions could decline during a fixed holding period within a stated confidence level, measured in accordance with section 4 of this appendix.

SECTION 3—Adjustments to the Risk-Based Capital Ratio Calculations

(a) *Risk-based capital ratio denominator.* A bank subject to this appendix shall calculate its risk-based capital ratio denominator as follows:

(1) *Adjusted risk-weighted assets.* Calculate adjusted risk-weighted assets, which equals risk-weighted assets (as determined in accordance with appendix A of this part), excluding the risk-weighted amounts of all covered positions (except foreign-exchange positions outside the trading account and over-the-counter derivative positions).[7]

(2) *Measure for market risk.* Calculate the measure for market risk, which equals the sum of the VAR-based capital charge, the specific risk add-on (if any), and the capital charge for de minimis exposures (if any).

(i) *VAR-based capital charge.* The VAR-based capital charge equals the higher of—

(A) the previous day's VAR measure; or

(B) the average of the daily VAR measures for each of the preceding 60 business days multiplied by three, except as provided in section 4(e) of this appendix;

(ii) *Specific risk add-on.* The specific risk add-on is calculated in accordance with section 5 of this appendix; and

(iii) *Capital charge for de minimis exposure.* The capital charge for de minimis exposure is calculated in accordance with section 4(a) of this appendix.

(3) *Market-risk-equivalent assets.* Calculate market-risk-equivalent assets by multiplying the measure for market risk (as calculated in paragraph (a)(2) of this section) by 12.5.

(4) *Denominator calculation.* Add market-risk-equivalent assets (as calculated in paragraph (a)(3) of this section) to adjusted risk-weighted assets (as calculated in paragraph (a)(1) of this section). The resulting sum is the bank's risk-based capital ratio denominator.

(b) *Risk-based capital ratio numerator.* A bank subject to this appendix shall calculate its risk-based capital ratio numerator by allocating capital as follows:

(1) *Credit-risk allocation.* Allocate tier 1 and tier 2 capital equal to 8.0 percent of adjusted risk-weighted assets (as calculated in paragraph (a)(1) of this section).[8]

(2) *Market-risk allocation.* Allocate tier 1, tier 2, and tier 3 capital equal to the measure for market risk as calculated in paragraph (a)(2) of this section. The sum of tier 2 and tier 3 capital allocated for market risk must not exceed 250 percent of tier 1 capital allocated for market risk. (This requirement means that tier 1 capital allocated in

[7] Foreign-exchange positions outside the trading account and all over-the-counter derivative positions, whether or not in the trading account, must be included in adjusted risk-weighted assets as determined in appendix A of this part.

[8] A bank may not allocate tier 3 capital to support credit risk (as calculated under appendix A of this part).

this paragraph (b)(2) must equal at least 28.6 percent of the measure for market risk.)

(3) *Restrictions.*

(i) The sum of tier 2 capital (both allocated and excess) and tier 3 capital (allocated in paragraph (b)(2) of this section) may not exceed 100 percent of tier 1 capital (both allocated and excess).[9]

(ii) Term subordinated debt (and intermediate-term preferred stock and related surplus) included in tier 2 capital (both allocated and excess) may not exceed 50 percent of tier 1 capital (both allocated and excess).

(4) *Numerator calculation.* Add tier 1 capital (both allocated and excess), tier 2 capital (both allocated and excess), and tier 3 capital (allocated under paragraph (b)(2) of this section). The resulting sum is the bank's risk-based capital ratio numerator.

SECTION 4—Internal Models

(a) *General.* For risk-based capital purposes, a bank subject to this appendix must use its internal model to measure its daily VAR, in accordance with the requirements of this section.[10] The Federal Reserve may permit a bank to use alternative techniques to measure the market risk of de minimis exposures so long as the techniques adequately measure associated market risk.

(b) *Qualitative requirements.* A bank subject to this appendix must have a risk-management system that meets the following minimum qualitative requirements:

(1) The bank must have a risk-control unit that reports directly to senior management and is independent from business-trading units.

(2) The bank's internal risk-measurement model must be integrated into the daily management process.

(3) The bank's policies and procedures must identify, and the bank must conduct, appropriate stress tests and backtests.[11] The bank's policies and procedures must identify the procedures to follow in response to the results of such tests.

(4) The bank must conduct independent reviews of its risk measurement and risk-management systems at least annually.

(c) *Market-risk factors.* The bank's internal model must use risk factors sufficient to measure the market risk inherent in all covered positions. The risk factors must address interest-rate risk,[12] equity-price risk, foreign-exchange-rate risk, and commodity-price risk.

(d) *Quantitative requirements.* For regulatory capital purposes, VAR measures must meet the following quantitative requirements:

(1) The VAR measures must be calculated on a daily basis using a 99 percent, one-tailed confidence level with a price shock equivalent to a ten-business-day movement in rates and prices. In order to calculate VAR measures based on a ten-day price shock, the bank may either calculate ten-day figures directly or convert VAR figures based on holding periods other than ten days to the equivalent of a ten-day holding period (for instance, by multiplying a one-day VAR measure by the square root of ten).

(2) The VAR measures must be based on an historical observation period (or effective observation period for a bank using a

[9] Excess tier 1 capital means tier 1 capital that has not been allocated in paragraphs (b)(1) and (b)(2) of this section. Excess tier 2 capital means tier 2 capital that has not been allocated in paragraph (b)(1) and (b)(2) of this section, subject to the restrictions in paragraph (b)(3) of this section.

[10] A bank's internal model may use any generally accepted measurement techniques, such as variance-covariance models, historical simulations, or Monte Carlo simulations. However, the level of sophistication and accuracy of a bank's internal model must be commensurate with the nature and size of its covered positions. A bank that modifies its existing modeling procedures to comply with the requirements of this appendix for risk-based capital purposes should, nonetheless, continue to use the internal model it considers most appropriate in evaluating risks for other purposes.

[11] Stress tests provide information about the impact of adverse market events on a bank's covered positions. Backtests provide information about the accuracy of an internal model by comparing a bank's daily VAR measures to its corresponding daily trading profits and losses.

[12] For material exposures in the major currencies and markets, modeling techniques must capture spread risk and must incorporate enough segments of the yield curve—at least six—to capture differences in volatility and less-than-perfect correlation of rates along the yield curve.

weighting scheme or other similar method) of at least one year. The bank must update data sets at least once every three months or more frequently as market conditions warrant.

(3) The VAR measures must include the risks arising from the nonlinear price characteristics of options positions and the sensitivity of the market value of the positions to changes in the volatility of the underlying rates or prices. A bank with a large or complex options portfolio must measure the volatility of options positions by different maturities.

(4) The VAR measures may incorporate empirical correlations within and across risk categories, provided that the bank's process for measuring correlations is sound. In the event that the VAR measures do not incorporate empirical correlations across risk categories, then the bank must add the separate VAR measures for the four major risk categories to determine its aggregate VAR measure.

(e) *Backtesting.*

(1) Beginning one year after a bank starts to comply with this appendix, a bank must conduct backtesting by comparing each of its most recent 250 business days' actual net trading profit or loss[13] with the corresponding daily VAR measures generated for internal risk-measurement purposes and calibrated to a one-day holding period and a 99 percent, one-tailed confidence level.

(2) Once each quarter, the bank must identify the number of exceptions, that is, the number of business days for which the magnitude of the actual daily net trading loss, if any, exceeds the corresponding daily VAR measure.

(3) A bank must use the multiplication factor indicated in table 1 of this appendix in determining its capital charge for market risk under section 3(a)(2)(i)(B) of this appendix until it obtains the next quarter's backtesting results, unless the Federal Reserve determines that a different adjustment or other action is appropriate.

SECTION 5—Specific Risk

(a) *Specific-risk add-on.* For purposes of section 3(a)(2)(ii) of this appendix, a bank's specific-risk add-on equals the standard specific-risk capital charge calculated under paragraph (c) of this section. If, however, a bank can demonstrate to the Federal Reserve that its internal model measures the specific risk of covered debt and/or equity positions and that those measures are included in the VAR-based capital charge in section 3(a)(2)(i) of this appendix, then the bank may reduce or eliminate its specific-risk add-on under this section. The determination as to whether a model incorporates specific risk must be made separately for covered debt and equity positions.

(1) If a model includes the specific risk of covered debt positions but not covered equity positions (or vice versa), then the bank can reduce its specific-risk charge for the included positions under paragraph (b) of this section. The specific-risk charge for the positions not included equals the standard specific-risk capital charge under paragraph (c) of this section.

(2) If a model addresses the specific risk of both covered debt and equity positions, then the bank can reduce its specific-risk charge for both covered debt and equity positions under paragraph (b) of this section. In this case, the comparison described in paragraph (b) of this section must be based on the total VAR-based figure for the specific risk of debt and equity positions, taking into account any correlations that are built into the model.

(b) *VAR-based specific-risk capital charge.* In all cases where a bank measures specific risk in its internal model, the total capital charge for specific risk (i.e., the VAR-based specific-risk capital charge plus the specific-risk add-on) must equal at least 50 percent of the standard specific-risk capital charge (this amount is the minimum specific-risk charge).

(1) If the portion of a bank's VAR measure that is attributable to specific risk (multi-

[13] Actual net trading profits and losses typically include such things as realized and unrealized gains and losses on portfolio positions as well as fee income and commissions associated with trading activities.

plied by the bank's multiplication factor if required in section 3(a)(2) of this appendix) is greater than or equal to the minimum specific-risk charge, then the bank has no specific-risk add-on and its capital charge for specific risk is the portion included in the VAR measure.

(2) If the portion of a bank's VAR measure that is attributable to specific risk (multiplied by the bank's multiplication factor if required in section 3(a)(2) of this appendix) is less than the minimum specific-risk charge, then the bank's specific-risk add-on is the difference between the minimum specific-risk charge and the specific-risk portion of the VAR measure (multiplied by the bank's multiplication factor if required in section 3(a)(2) of this appendix).

(c) *Standard specific-risk capital charge.* The standard specific-risk capital charge equals the sum of the components for covered debt and equity positions as follows:

(1) *Covered debt positions.*

(i) For purposes of this section 5, "covered debt positions" means fixed-rate or floating-rate debt instruments located in the trading account and instruments located in the trading account with values that react primarily to changes in interest rates, including certain nonconvertible preferred stock, convertible bonds, and instruments subject to repurchase and lending agreements. Also included are derivatives (including written and purchased options) for which the underlying instrument is a covered debt instrument that is subject to a non-zero specific-risk capital charge.

(A) For covered debt positions that are derivatives, a bank must risk-weight (as described in paragraph (c)(1)(iii) of this section) the market value of the effective notional amount of the underlying debt instrument or index portfolio. Swaps must be included as the notional position in the underlying debt instrument or index portfolio, with a receiving side treated as a long position and a paying side treated as a short position.

(B) For covered debt positions that are options, whether long or short, a bank must risk-weight (as described in paragraph (c)(1)(iii) of this section) the market value of the effective notional amount of the underlying debt instrument or index multiplied by the option's delta.

(ii) A bank may net long and short covered debt positions (including derivatives) in identical debt issues or indices.

(iii) A bank must multiply the absolute value of the current market value of each net long or short covered debt position by the appropriate specific-risk weighting factor indicated in table 2 of this appendix. The specific risk capital charge component for covered debt positions is the sum of the weighted values.

(A) The *government* category includes all debt instruments of central governments of OECD-based countries[14] including bonds, Treasury bills, and other short-term instruments, as well as local currency instruments of non-OECD central governments to the extent the bank has liabilities booked in that currency.

(B) The *qualifying* category includes debt instruments of U.S. government-sponsored agencies, general-obligation debt instruments issued by states and other political subdivisions of OECD-based countries, multilateral development banks, and debt instruments issued by U.S. depository institutions or OECD-banks that do not qualify as capital of the issuing institution.[15] This category also includes other debt instruments, including corporate debt and revenue instruments issued by states and other political subdivisions of OECD countries, that are—

(*1*) rated investment-grade by at least two nationally recognized credit-rating services;

(*2*) rated investment-grade by one

[14] Organization for Economic Cooperation and Development (OECD)-based countries is defined in appendix A of this part.

[15] U.S. government–sponsored agencies, multilateral development banks, and OECD banks are defined in appendix A of this part.

nationally recognized credit rating agency and not rated less than investment-grade by any other credit-rating agency; or

(*3*) unrated, but deemed to be of comparable investment quality by the reporting bank and the issuer has instruments listed on a recognized stock exchange, subject to review by the Federal Reserve.

(C) The *other* category includes debt instruments that are not included in the government or qualifying categories.

(2) *Covered equity positions.*

(i) For purposes of this section 5, "covered equity positions" means equity instruments located in the trading account and instruments located in the trading account with values that react primarily to changes in equity prices, including voting or nonvoting common stock, certain convertible bonds, and commitments to buy or sell equity instruments. Also included are derivatives (including written and purchased options) for which the underlying is a covered equity position.

(A) For covered equity positions that are derivatives, a bank must risk-weight (as described in paragraph (c)(2)(iii) of this section) the market value of the effective notional amount of the underlying equity instrument or equity portfolio. Swaps must be included as the notional position in the underlying equity instrument or index portfolio, with a receiving side treated as a long position and a paying side treated as a short position.

(B) For covered equity positions that are options, whether long or short, a bank must risk-weight (as described in paragraph (c)(2)(iii) of this section) the market value of the effective notional amount of the underlying equity instrument or index multiplied by the option's delta.

(ii) A bank may net long and short covered equity positions (including derivatives) in identical equity issues or equity indices in the same market.[16]

(iii) (A) A bank must multiply the absolute value of the current market value of each net long or short covered equity position by a risk-weighting factor of 8.0 percent, or by 4.0 percent if the equity is held in a portfolio that is both liquid and well diversified.[17] For covered equity positions that are index contracts comprising a well-diversified portfolio of equity instruments, the net long or short position is multiplied by a risk-weighting factor of 2.0 percent.

(B) For covered equity positions from the following futures-related arbitrage strategies, a bank may apply a 2.0 percent risk-weighting factor to one side (long or short) of each position with the opposite side exempt from charge, subject to review by the Federal Reserve:

(*1*) long and short positions in exactly the same index at different dates or in different market centers; or

(*2*) long and short positions in index contracts at the same date in different but similar indices.

(C) For futures contracts on broadly based indices that are matched by offsetting positions in a basket of stocks comprising the index, a bank may apply a 2.0 percent risk-weighting factor to the futures and stock basket positions (long and short), provided that such trades are deliberately entered into and separately controlled, and that the basket of stocks comprises at least 90 percent of the capitalization of the index.

(iv) The specific-risk capital-charge

[16] A bank may also net positions in depository receipts against an opposite position in the underlying equity or identical equity in different markets, provided that the bank includes the costs of conversion.

[17] A portfolio is liquid and well diversified if (1) it is characterized by a limited sensitivity to price changes of any single equity issue or closely related group of equity issues held in the portfolio; (2) the volatility of the portfolio's value is not dominated by the volatility of any individual equity issue or by equity issues from any single industry or economic sector; (3) it contains a large number of individual equity positions, with no single position representing a substantial portion of the portfolio's total market value; and (4) it consists mainly of issues traded on organized exchanges or in well-established over-the-counter markets.

component for covered equity positions is the sum of the weighted values.

Table 1—Multiplication Factor Based on Results of Backtesting

Number of exceptions	*Multiplication factor*
4 or fewer	3.00
5	3.40
6	3.50
7	3.65
8	3.75
9	3.85
10 or more	4.00

Table 2—Specific-Risk Weighting Factors for Covered Debt Positions

Category	*Remaining maturity (contractual)*	*Weighting factor (in percent)*
Government	N/A	0.00
Qualifying	6 months or less	0.25
	over 6 months to 24 months	1.00
	over 24 months	1.60
Other	N/A	8.00

Capital Adequacy Guidelines for Bank Holding Companies: Market-Risk Measure

12 CFR 225, appendix E; effective January 1, 1997

SECTION 1—Purpose, Applicability, Scope, and Effective Date

(a) *Purpose.* The purpose of this appendix is to ensure that bank holding companies (organizations) with significant exposure to market risk maintain adequate capital to support that exposure.[1] This appendix supplements and adjusts the risk-based capital ratio calculations under appendix A of this part with respect to those organizations.

(b) *Applicability.*

(1) This appendix applies to any bank holding company whose trading activity[2] (on a worldwide consolidated basis) equals—

(i) 10 percent or more of total assets;[3] or

(ii) $1 billion or more.

(2) The Federal Reserve may additionally apply this appendix to any bank holding company if the Federal Reserve deems it necessary or appropriate for safe and sound banking practices.

(3) The Federal Reserve may exclude a bank holding company otherwise meeting the criteria of paragraph (b)(1) of this section from coverage under this appendix if it determines the organization meets such criteria as a consequence of accounting, operational, or similar considerations, and the Federal Reserve deems it consistent with safe and sound banking practices.

(c) *Scope.* The capital requirements of this appendix support market risk associated with an organization's covered positions.

(d) *Effective date.* This appendix is effective as of January 1, 1997. Compliance is not mandatory until January 1, 1998. Subject to supervisory approval, a bank holding company may opt to comply with this appendix as early as January 1, 1997.[4]

SECTION 2—Definitions

For purposes of this appendix, the following definitions apply:

(a) *Covered positions* means all positions in an organization's trading account, and all foreign-exchange[5] and commodity positions, whether or not in the trading account.[6] Positions include on-balance-sheet assets and liabilities and off-balance-sheet items. Securities subject to repurchase and lending agreements are included as if still owned by the lender.

(b) *Market risk* means the risk of loss resulting from movements in market prices. Market risk consists of general market risk and specific risk components.

(1) *General market risk* means changes in the market value of covered positions resulting from broad market movements, such as changes in the general level of interest

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1. This appendix is based on a framework developed jointly by supervisory authorities from the countries represented on the Basle Committee on Banking Supervision and endorsed by the Group of Ten Central Bank Governors. The framework is described in a Basle Committee paper entitled "Amendment to the Capital Accord to Incorporate Market Risk," January 1996.

2. Trading activity means the gross sum of trading assets and liabilities as reported in the bank holding company's most recent quarterly Y-9C Report.

3. Total assets means quarter-end total assets as reported in the bank holding company's most recent Y-9C Report.

4. A bank holding company that voluntarily complies with the final rule prior to January 1, 1998, must comply with all of its provisions.

5. Subject to supervisory review, a bank may exclude structural positions in foreign currencies from its covered positions.

6. The term trading account is defined in the instructions to the call report.

rates, equity prices, foreign-exchange rates, or commodity prices.

(2) *Specific risk* means changes in the market value of specific positions due to factors other than broad market movements and includes such risk as the credit risk of an instrument's issuer.

(c) *Tier 1* and *tier 2 capital* are defined in appendix A of this part.

(d) *Tier 3 capital* is subordinated debt that is unsecured; is fully paid up; has an original maturity of at least two years; is not redeemable before maturity without prior approval by the Federal Reserve; includes a lock-in clause precluding payment of either interest or principal (even at maturity) if the payment would cause the issuing organization's risk-based capital ratio to fall or remain below the minimum required under appendix A of this part; and does not contain and is not covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices.

(e) *Value-at-risk (VAR)* means the estimate of the maximum amount that the value of covered positions could decline due to market price or rate movements during a fixed holding period within a stated confidence level, measured in accordance with section 4 of this appendix.

SECTION 3—Adjustments to the Risk-Based Capital Ratio Calculations

(a) *Risk-based capital ratio denominator.* An organization subject to this appendix shall calculate its risk-based capital ratio denominator as follows:

(1) *Adjusted risk-weighted assets.* Calculate adjusted risk-weighted assets, which equals risk-weighted assets (as determined in accordance with appendix A of this part) excluding the risk-weighted amounts of all covered positions (except foreign-exchange positions outside the trading account and over-the-counter derivative positions).[7]

(2) *Measure for market risk.* Calculate the measure for market risk, which equals the sum of the VAR-based capital charge, the specific risk add-on (if any), and the capital charge for de minimis exposures (if any).

(i) *VAR-based capital charge.* The VAR-based capital charge equals the higher of—

(A) the previous day's VAR measure; or

(B) the average of the daily VAR measures for each of the preceding 60 business days multiplied by three, except as provided in section 4(e) of this appendix;

(ii) *Specific risk add-on.* The specific risk add-on is calculated in accordance with section 5 of this appendix; and

(iii) *Capital charge for de minimis exposure.* The capital charge for de minimis exposure is calculated in accordance with section 4(a) of this appendix.

(3) *Market-risk-equivalent assets.* Calculate market-risk-equivalent assets by multiplying the measure for market risk (as calculated in paragraph (a)(2) of this section) by 12.5.

(4) *Denominator calculation.* Add market-risk-equivalent assets (as calculated in paragraph (a)(3) of this section) to adjusted risk-weighted assets (as calculated in paragraph (a)(1) of this section). The resulting sum is the organization's risk-based capital ratio denominator.

(b) *Risk-based capital ratio numerator.* An organization subject to this appendix shall calculate its risk-based capital ratio numerator by allocating capital as follows:

(1) *Credit risk allocation.* Allocate tier 1 and tier 2 capital equal to 8.0 percent of adjusted risk-weighted assets (as calculated in paragraph (a)(1) of this section).[8]

(2) *Market-risk allocation.* Allocate tier 1, tier 2, and tier 3 capital equal to the measure for market risk as calculated in paragraph (a)(2) of this section. The sum of tier 2 and tier 3 capital allocated for market risk must not exceed 250 percent of tier 1 capital allocated for market risk. (This requirement means that tier 1 capital allocated in

[7] Foreign-exchange positions outside the trading account and all over-the-counter derivative positions, whether or not in the trading account, must be included in adjusted risk-weighted assets as determined in appendix A of this part.

[8] An institution may not allocate tier 3 capital to support credit risk (as calculated under appendix A of this part).

this paragraph (b)(2) must equal at least 28.6 percent of the measure for market risk.)

(3) *Restrictions.*

(i) The sum of tier 2 capital (both allocated and excess) and tier 3 capital (allocated in paragraph (b)(2) of this section) may not exceed 100 percent of tier 1 capital (both allocated and excess).[9]

(ii) Term subordinated debt (and intermediate-term preferred stock and related surplus) included in tier 2 capital (both allocated and excess) may not exceed 50 percent of tier 1 capital (both allocated and excess).

(4) *Numerator calculation.* Add tier 1 capital (both allocated and excess), tier 2 capital (both allocated and excess), and tier 3 capital (allocated under paragraph (b)(2) of this section). The resulting sum is the organization's risk-based capital ratio numerator.

SECTION 4—Internal Models

(a) *General.* For risk-based capital purposes, a bank holding company subject to this appendix must use its internal model to measure its daily VAR, in accordance with the requirements of this section.[10] The Federal Reserve may permit an organization to use alternative techniques to measure the market risk of de minimis exposures so long as the techniques adequately measure associated market risk.

(b) *Qualitative requirements.* A bank holding company subject to this appendix must have a risk-management system that meets the following minimum qualitative requirements:

(1) The organization must have a risk-control unit that reports directly to senior management and is independent from business-trading units.

(2) The organization's internal risk-measurement model must be integrated into the daily management process.

(3) The organization's policies and procedures must identify, and the organization must conduct, appropriate stress tests and backtests.[11] The organization's policies and procedures must identify the procedures to follow in response to the results of such tests.

(4) The organization must conduct independent reviews of its risk-measurement and risk-management systems at least annually.

(c) *Market-risk factors.* The organization's internal model must use risk factors sufficient to measure the market risk inherent in all covered positions. The risk factors must address interest-rate risk,[12] equity-price risk, foreign-exchange-rate risk, and commodity-price risk.

(d) *Quantitative requirements.* For regulatory capital purposes, VAR measures must meet the following quantitative requirements:

(1) The VAR measures must be calculated on a daily basis using a 99 percent, one-tailed confidence level with a price shock equivalent to a ten-business-day movement in rates and prices. In order to calculate VAR measures based on a ten-day price shock, the organization may either calculate ten-day figures directly or convert VAR figures based on holding periods other than ten days to the equivalent of a ten-day holding period (for instance, by multiplying a one-day VAR measure by the square root of ten).

(2) The VAR measures must be based on an historical observation period (or effective observation period for an organization using

[9] Excess tier 1 capital means tier 1 capital that has not been allocated in paragraphs (b)(1) and (b)(2) of this section. Excess tier 2 capital means tier 2 capital that has not been allocated in paragraph (b)(1) and (b)(2) of this section, subject to the restrictions in paragraph (b)(3) of this section.

[10] An organization's internal model may use any generally accepted measurement techniques, such as variance-covariance models, historical simulations, or Monte Carlo simulations. However, the level of sophistication and accuracy of an organization's internal model must be commensurate with the nature and size of its covered positions. An organization that modifies its existing modeling procedures to comply with the requirements of this appendix for risk-based capital purposes should, nonetheless, continue to use the internal model it considers most appropriate in evaluating risks for other purposes.

[11] Stress tests provide information about the impact of adverse market events on a bank's covered positions. Backtests provide information about the accuracy of an internal model by comparing an organization's daily VAR measures to its corresponding daily trading profits and losses.

[12] For material exposures in the major currencies and markets, modeling techniques must capture spread risk and must incorporate enough segments of the yield curve—at least six—to capture differences in volatility and less than perfect correlation of rates along the yield curve.

a weighting scheme or other similar method) of at least one year. The organization must update data sets at least once every three months or more frequently as market conditions warrant.

(3) The VAR measures must include the risks arising from the nonlinear price characteristics of options positions and the sensitivity of the market value of the positions to changes in the volatility of the underlying rates or pries. An organization with a large or complex options portfolio must measure the volatility of options positions by different maturities.

(4) The VAR measures may incorporate empirical correlations within and across risk categories, provided that the organization's process for measuring correlations is sound. In the event that the VAR measures do not incorporate empirical correlations across risk categories, then the organization must add the separate VAR measures for the four major risk categories to determine its aggregate VAR measure.

(e) *Backtesting.*

(1) Beginning one year after a bank holding company starts to comply with this appendix, it must conduct backtesting by comparing each of its most recent 250 business days' actual net trading profit or loss[13] with the corresponding daily VAR measures generated for internal risk-measurement purposes and calibrated to a one-day holding period and a 99th percentile, one-tailed confidence level.

(2) Once each quarter, the organization must identify the number of exceptions, that is, the number of business days for which the magnitude of the actual daily net trading loss, if any, exceeds the corresponding daily VAR measure.

(3) A bank holding company must use the multiplication factor indicated in table 1 of this appendix in determining its capital charge for market risk under section 3(a)(2)(i)(B) of this appendix until it obtains the next quarter's backtesting results, unless the Federal Reserve determines that a different adjustment or other action is appropriate.

[13] Actual net trading profits and losses typically include such things as realized and unrealized gains and losses on portfolio positions as well as fee income and commissions associated with trading activities.

SECTION 5—Specific Risk

(a) *Specific-risk add-on.* For purposes of section 3(a)(2)(ii) of this appendix, a bank holding company's specific-risk add-on equals the standard specific-risk capital charge calculated under paragraph (c) of this section. If, however, an organization can demonstrate to the Federal Reserve that its internal model measures the specific risk of covered debt and/or equity positions and that those measures are included in the VAR-based capital charge in section 3(a)(2)(i) of this appendix, then it may reduce or eliminate its specific-risk add-on under this section. The determination as to whether a model incorporates specific risk must be made separately for covered debt and equity positions.

(1) If a model includes the specific risk of covered debt positions but not covered equity positions (or vice versa), then the organization can reduce its specific-risk charge for the included positions under paragraph (b) of this section. The specific-risk charge for the positions not included equals the standard specific-risk capital charge under paragraph (c) of this section.

(2) If a model addresses the specific risk of both covered debt and equity positions, then the organization can reduce its specific-risk charge for both covered debt and equity positions under paragraph (b) of this section. In this case, the comparison described in paragraph (b) of this section must be based on the total VAR-based figure for the specific risk of debt and equity positions, taking account of any correlations that are built into the model.

(b) *VAR-based specific-risk capital charge.* In all cases where a bank holding company measures specific risk in its internal model, the total capital charge for specific risk (i.e., the VAR-based specific-risk capital charge plus the specific-risk add-on) must equal at least 50 percent of the standard specific-risk capital charge (this amount is the minimum specific-risk charge).

(1) If the portion of an organization's VAR measure that is attributable to specific risk (multiplied by the organization's multiplication factor if required in section 3(a)(2) of this appendix) is greater than or equal to the minimum specific-risk charge, then the organization has no specific-risk add-on and its capital charge for specific risk is the portion included in the VAR measure.

(2) If the portion of an organization's VAR measure that is attributable to specific risk (multiplied by the organization's multiplication factor if required in section 3(a)(2) of this appendix) is less than the minimum specific-risk charge, then the organization's specific-risk add-on is the difference between the minimum specific-risk charge and the specific-risk portion of the VAR measure (multiplied by the multiplication factor if required in section 3(a)(2) of this appendix).

(c) *Standard specific-risk capital charge.* The standard specific-risk capital charge equals the sum of the components for covered debt and equity positions as follows:

(1) *Covered debt positions.*

(i) For purposes of this section 5, covered debt positions means fixed-rate or floating-rate debt instruments located in the trading account or instruments located in the trading account with values that react primarily to changes in interest rates, including certain nonconvertible preferred stock, convertible bonds, and instruments subject to repurchase and lending agreements. Also included are derivatives (including written and purchased options) for which the underlying instrument is a covered debt instrument that is subject to a non-zero specific risk capital charge.

(A) For covered debt positions that are derivatives, an organization must risk-weight (as described in paragraph (c)(1)(iii) of this section) the market value of the effective notional amount of the underlying debt instrument or index portfolio. Swaps must be included as the notional position in the underlying debt instrument or index portfolio, with a receiving side treated as a long position and a paying side treated as a short position.

(B) For covered debt positions that are options, whether long or short, an organization must risk-weight (as described in paragraph (c)(1)(iii) of this section) the market value of the effective notional amount of the underlying debt instrument or index multiplied by the option's delta.

(ii) An organization may net long and short covered debt positions (including derivatives) in identical debt issues or indices.

(iii) An organization must multiply the absolute value of the current market value of each net long or short covered debt position by the appropriate specific-risk weighting factor indicated in table 2 of this appendix. The specific-risk capital charge component for covered debt positions is the sum of the weighted values.

(A) The *government* category includes all debt instruments of central governments of OECD-based countries[14] including bonds, Treasury bills, and other short-term instruments, as well as local currency instruments of non-OECD central governments to the extent the organization has liabilities booked in that currency.

(B) The *qualifying* category includes debt instruments of U.S. government–sponsored agencies, general obligation debt instruments issued by states and other political subdivisions of OECD-based countries, multilateral development banks, and debt instruments issued by U.S. depository institutions or OECD banks that do not qualify as capital of the issuing institution.[15] This category also includes other debt instruments, including corporate debt and revenue instruments issued by states

[14] Organization for Economic Cooperation and Development (OECD)-based countries is defined in appendix A of this part.

[15] U.S. government-sponsored agencies, multilateral development banks, and OECD banks are defined in appendix A of this part.

and other political subdivisions of OECD countries, that are—

(*1*) rated investment-grade by at least two nationally recognized credit rating services;

(*2*) rated investment grade by one nationally recognized credit rating agency and not rated less than investment grade by any other credit rating agency; or

(*3*) unrated, but deemed to be of comparable investment quality by the reporting organization and the issuer has instruments listed on a recognized stock exchange, subject to review by the Federal Reserve.

(C) The *other* category includes debt instruments that are not included in the government or qualifying categories.

(2) *Covered equity positions.*

(i) For purposes of this section 5, covered equity positions means equity instruments located in the trading account and instruments located in the trading account with values that react primarily to changes in equity prices, including voting or nonvoting common stock, certain convertible bonds, and commitments to buy or sell equity instruments. Also included are derivatives (including written or purchased options) for which the underlying is a covered equity position.

(A) For covered equity positions that are derivatives, an organization must risk-weight (as described in paragraph (c)(2)(iii) of this section) the market value of the effective notional amount of the underlying equity instrument or equity portfolio. Swaps must be included as the notional position in the underlying equity instrument or index portfolio, with a receiving side treated as a long position and a paying side treated as a short position.

(B) For covered equity positions that are options, whether long or short, an organization must risk-weight (as described in paragraph (c)(2)(iii) of this section) the market value of the effective notional amount of the underlying equity instrument or index multiplied by the option's delta.

(ii) An organization may net long and short covered equity positions (including derivatives) in identical equity issues or equity indices in the same market.[16]

(iii) (A) An organization must multiply the absolute value of the current market value of each net long or short covered equity position by a risk-weighting factor of 8.0 percent, or by 4.0 percent if the equity is held in a portfolio that is both liquid and well diversified.[17] For covered equity positions that are index contracts comprising a well-diversified portfolio of equity instruments, the net long or short position is to be multiplied by a risk-weighting factor of 2.0 percent.

(B) For covered equity positions from the following futures-related arbitrage strategies, an organization may apply a 2.0 percent risk-weighting factor to one side (long or short) of each equity position with the opposite side exempt from charge, subject to review by the Federal Reserve:

(*1*) long and short positions in exactly the same index at different dates or in different market centers; or

(*2*) long and short positions in index contracts at the same date in different but similar indices.

(C) For futures contracts on broadly based indices that are matched by offsetting positions in a basket of stocks comprising the index, an organization may apply a 2.0 percent risk-weighting factor to the futures and stock basket positions (long and short), provided

[16] An organization may also net positions in depository receipts against an opposite position in the underlying equity or identical equity in different markets, provided that the organization includes the costs of conversion.

[17] A portfolio is liquid and well-diversified if (1) it is characterized by a limited sensitivity to price changes of any single equity issue or closely related group of equity issues held in the portfolio; (2) the volatility of the portfolio's value is not dominated by the volatility of any individual equity issue or by equity issues from any single industry or economic sector; (3) it contains a large number of individual equity positions, with no single position representing a substantial portion of the portfolio's total market value; and (4) it consists mainly of issues traded on organized exchanges or in well-established over-the-counter markets.

that such trades are deliberately entered into and separately controlled, and that the basket of stocks comprises at least 90 percent of the capitalization of the index.

(iv) The specific-risk capital charge component for covered equity positions is the sum of the weighted values.

Table 1—Multiplication Factor Based on Results of Backtesting

Number of exceptions	*Multiplication factor*
4 or fewer	3.00
5	3.40
6	3.50
7	3.65
8	3.75
9	3.85
10 or more	4.00

Table 2—Specific-Risk Weighting Factors for Covered Debt Positions

Category	*Remaining maturity (contractual)*	*Weighting factor (in percent)*
Government	N/A	0.00
Qualifying	6 months or less	0.25
	over 6 months to 24 months	1.00
	over 24 months	1.60
Other	N/A	8.00