



FEDERAL RESERVE BANK
OF DALLAS

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

DALLAS, TEXAS
75265-5906

November 28, 1997

Notice 97-110

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

SUBJECT

**Request for Public Comments on Risk-Based
Capital Standards**

DETAILS

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (collectively, the Agencies) are proposing to amend their respective risk-based capital standards for banks, bank holding companies, and thrifts, with regard to the treatment of unrealized holding gains on certain equity securities. These gains are reported as a component of equity capital under U.S. generally accepted accounting principles (GAAP) but currently are not included in regulatory capital under the Agencies' capital standards. The proposal, if adopted as a final rule, would establish uniform interagency rules permitting institutions to include in supplementary (Tier 2) capital up to 45 percent of unrealized gains on certain available-for-sale equity securities. The Agencies' proposal is consistent with the prudential standards of the Basle Accord.

Also, the Agencies are proposing to amend their risk-based capital standards and leverage capital standards for banks and thrifts. The proposal would represent a significant step in implementing section 303 of the Riegle Community Development and Regulatory Improvement Act of 1994, with regard to the Agencies' capital adequacy standards. The proposal would result in the Agencies having uniform risk-based capital treatments for construction loans on presold residential properties, real estate loans secured by junior liens on 1- to 4-family residential properties, and investments in mutual funds, as well as uniform and simplified minimum Tier 1 capital leverage standards.

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.

In conjunction with the above proposal, the Board is also proposing to amend its risk-based capital guidelines for bank holding companies by revising the treatment for junior liens on 1- to 4- family residential properties and mutual funds, revising the language for construction loans on presold residential properties, and simplifying the leverage capital guidelines for bank holding companies. Also, the proposal would implement part of section 303 of the Riegle Community Development and Regulatory Improvement Act of 1994. The proposal would result in consistency between the bank holding company risk-based capital standards and the risk-based capital standards of the other Federal banking and thrift regulatory agencies. In addition, the bank holding company Tier 1 leverage standards would be simplified and revised to take into account the market risk capital rule.

The Board must receive comments by December 26, 1997. Please address comments to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, DC 20551. Comments should refer to Docket No. R-0982 for unrealized holding gains on certain equity securities; Docket No. R-0947 for construction loans on presold residential properties, junior liens, and mutual funds and leverage capital standards (**banks and thrifts**); or to Docket No. R-0948 for construction loans on presold residential properties, junior liens, and mutual funds and leverage capital standards (**banks holding companies**).

ATTACHMENTS

A copy of the agencies' notices as they appear on pages 55681-94, Vol. 62, No. 207 of the *Federal Register* dated October 27, 1997, is attached.

MORE INFORMATION

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

Sincerely yours,

A handwritten signature in cursive script that reads "Robert D. McTeer, Jr." The signature is written in dark ink and is positioned below the typed name "Robert D. McTeer, Jr.".

Federal Register

Monday
October 27, 1997

Part III

Department of the Treasury

Office of the Comptroller of the Currency
12 CFR Part 3

Federal Reserve System

12 CFR Parts 208 and 225

Federal Deposit Insurance Corporation

12 CFR Part 325

Department of the Treasury

Office of Thrift Supervision
12 CFR Part 567

Risk Based Capital Standards: Unrealized Holding Gains on Certain Equity Securities; and Construction Loans on Presold Residential Properties, Junior Liens on 1- to 4-Family Residential Properties and Mutual Funds, and Leverage Capital Standards (Tier 1 Leverage Ratio); Proposed Rules

DEPARTMENT OF THE TREASURY**Office of the Comptroller of the Currency****12 CFR Part 3**

[Docket No. 97-18]

RIN 1557-AB14

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

[Regulations H and Y; Docket No. R-0982]

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

RIN 3064-AC11

DEPARTMENT OF THE TREASURY**Office of Thrift Supervision****12 CFR Part 567**

[Docket No. 97-109]

RIN 1550-AB11

Risk-Based Capital Standards; Unrealized Holding Gains on Certain Equity Securities

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

ACTION: Joint notice of proposed rulemaking.

SUMMARY: The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the Agencies) are proposing to amend their respective risk-based capital standards for banks, bank holding companies and thrifts (institutions) with regard to the treatment of unrealized holding gains on certain equity securities. These gains are reported as a component of equity capital under U.S. generally accepted accounting principles (GAAP), but currently are not included in regulatory capital under the Agencies' capital standards. The proposal, if adopted as a final rule, would establish uniform interagency rules permitting institutions to include in supplementary (Tier 2) capital up to 45 percent of unrealized gains on certain available-for-sale equity securities. The Agencies' proposal is consistent with the prudential standards of the Basle Accord.

DATES: Comments must be received on or before December 26, 1997.

ADDRESSES: Comments should be directed to:

OCC: Comments may be submitted to Docket No. 97-18, Communications Division, Third Floor, Office of the Comptroller of the Currency, 250 E Street, S.W., Washington, D.C., 20219. Comments will be available for inspection and photocopying at that address. In addition, comments may be sent by facsimile transmission to FAX number (202) 874-5274, or by electronic mail to REGS.COMMENTS@OCC.TREAS.GOV.

Board: Comments directed to the Board should refer to Docket No. R-0982 and may be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington D.C., 20551. Comments may also be delivered to Room B-2222 of the Eccles Building between 8:45 a.m. and 5:15 p.m. weekdays, or the guard station in the Eccles Building courtyard on 20th Street, N.W. (between Constitution Avenue and C Street) at any time. Comments may be inspected in Room MP-500 of the Martin Building between 9 a.m. and 5 p.m. weekdays, except as provided in 12 CFR 261.8 of the Board's Rules Regarding Availability of Information.

FDIC: Send written comments to Robert E. Feldman, Executive Secretary, Attention: Comments/OES, Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, D.C. 20429. Comments may be hand-delivered to the guard station at the rear of the 17th Street Building (located on F Street), on business days between 7:00 a.m. and 5:00 p.m. (FAX number (202)898-3838; Internet address: comments@fdic.gov). Comments may be inspected and photocopied in the FDIC Public Information Center, Room 100, 801 17th Street, N.W., Washington, D.C. 20429, between 9:00 a.m. and 4:30 p.m. on business days.

OTS: Send comments to Manager, Dissemination Branch, Records Management and Information Policy, Office of Thrift Supervision, 1700 G Street, N.W., Washington, D.C. 20552, Attention Docket No. 97-109. These submissions may be hand-delivered to 1700 G Street, N.W., from 9:00 a.m. to 5:00 p.m. on business days; they may be sent by facsimile transmission to FAX number (202) 906-7755, or they may be sent by e-mail: public.info@ots.treas.gov. Those commenting by e-mail should include their name and telephone number. Comments will be available for

inspection at 1700 G Street, N.W., from 9:00 a.m. until 4:00 p.m. on business days.

FOR FURTHER INFORMATION CONTACT:

OCC: Roger Tufts, Senior Economic Advisor (202/874-5070), Tom Rollo, National Bank Examiner (202/874-5070), Capital Policy Division; or Ronald Shimabukuro, Senior Attorney (202/874-5090), Legislative and Regulatory Activities Division.

Board: Roger Cole, Associate Director (202/452-2618); Norah Barger, Assistant Director (202/452-2402); or Barbara Bouchard, Senior Supervisory Financial Analyst (202/452-3072), Division of Banking Supervision and Regulation. For the hearing impaired *only*, Telecommunication Device for the Deaf (TDD), Diane Jenkins (202/452-3544).

FDIC: For supervisory issues, Stephen G. Pfeifer, Examination Specialist, Accounting Section, Division of Supervision (202/898-8904); for legal issues, Jamey Basham, Counsel, Legal Division (202/898-7265).

OTS: John F. Connolly, Senior Program Manager for Capital Policy (202/906-6465); Michael D. Solomon, Senior Policy Advisor (202/906-5654), Supervision Policy; Karen Osterloh, Assistant Chief Counsel (202/906-6639), or Vern McKinley, Senior Attorney (202/906-6241), Regulations and Legislation Division, Office of the Chief Counsel.

SUPPLEMENTARY INFORMATION: The Agencies' risk-based capital standards implementing the International Convergence of Capital Measurement and Capital Standards (the Basle Accord)¹ include definitions for core (Tier 1) capital and supplementary (Tier 2) capital.² Under the Agencies' capital standards, Tier 1 capital generally includes common stockholders' equity, noncumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries.³ The common stockholders' equity component is defined to include common stock; related surplus; and retained earnings

¹The Basle Accord is a risk-based framework developed by the Basle Committee on Banking Regulations and Supervisory Practices and endorsed by the central bank governors of the Group of Ten (G-10) countries in July 1988. The Committee is comprised of the central banks and supervisory authorities from the G-10 countries (Belgium, Canada, France, Germany, Italy, Netherlands, Sweden, Switzerland, the United Kingdom, and the United States) and Luxembourg.

²Refer to each Agency's risk-based capital standards for more detailed descriptions of core and supplementary capital.

³Bank holding companies may also include in Tier 1 capital limited amounts of cumulative perpetual preferred stock.

(including capital reserves and adjustments for the cumulative effect of foreign currency translation); less net unrealized holding losses on available-for-sale equity securities with readily determinable fair values. Net unrealized holding gains on such equity securities and net unrealized holding gains and losses on available-for-sale debt securities are not included in the Agencies' regulatory capital definition of common stockholders' equity.⁴

Tier 2 capital includes, subject to certain limitations and conditions, the allowance for loan and lease losses; cumulative perpetual preferred stock and related surplus; and certain other maturing or redeemable capital instruments. The Basle Accord also permits in Tier 2 capital up to 45 percent of the gross (i.e., pre-tax) unrealized gains on equity securities. The 55 percent discount is applied to the unrealized gains to reflect potential volatility of this form of unrealized capital, as well as tax liability charges that would be incurred if the unrealized gain were realized or otherwise taxed currently. When the Agencies implemented the Basle Accord by issuing their respective risk-based capital standards in 1989, they decided not to include such unrealized gains in Tier 2 capital.

The Agencies believe that it is appropriate to continue the existing regulatory capital treatment of unrealized gains and losses on available-for-sale debt securities and unrealized losses on available-for-sale equity securities. However, for institutions that have net unrealized holding gains on available-for-sale equity securities, the Agencies are considering whether it would be more reasonable, as well as more consistent with the Basle Accord, to include at least a portion of the unrealized gains on such securities in regulatory capital. Therefore, the Agencies have decided to issue, and request comment on, a proposed revision to the Agencies' rules.

Specifically, the Agencies are proposing to permit institutions that

⁴For regulatory capital purposes, institutions record net unrealized gains or losses on available-for-sale securities (debt and equity) in accordance with Statement of Financial Accounting Standards No. 115, "Accounting for Certain Investments in Debt and Equity Securities" (SFAS 115). Available-for-sale securities are all debt securities not held for trading that an institution does not have the positive intent and ability to hold until maturity and equity securities with readily determinable fair values not held for trading. Available-for-sale securities must be reported at fair value with unrealized gains or losses (i.e., the amount by which fair value exceeds or falls below amortized cost) reported, net of tax, directly in a separate component of common stockholders' equity.

legally hold equity securities to include in Tier 2 capital up to 45 percent of the pretax net unrealized holding gains (that is, the excess amount, if any, of the fair value over historical cost as reported in the institution's most recent quarterly regulatory report)⁵ on available-for-sale equity securities. The equity securities must be valued in accordance with GAAP and have readily determinable fair values⁶ and institutions should be able to substantiate those values. In the event that an Agency determines that an institution's available-for-sale equity securities are not prudently valued, the institution may be precluded from including all or a portion of the eligible pretax net unrealized gains on those securities in Tier 2 capital. The proposed 55 percent discount is not required by GAAP, but is consistent with the Basle Accord.

The Agencies clarify that net unrealized gains (losses) on other types of assets, such as bank premises and available-for-sale debt securities, are not included in supplementary capital, but may be taken into account when assessing an institution's overall capital adequacy.

The Agencies request comment on all aspects of this proposal.

Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act, the Agencies have determined that this proposed rule would not have a significant economic impact on a substantial number of small entities in accordance with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). Accordingly, a regulatory flexibility analysis is not required. The proposed rule would permit institutions to

⁵The Consolidated Report of Condition and Income for banks supervised by the OCC, the Board, or the FDIC; the Thrift Financial Report for thrift institutions supervised by the OTS; and the Y-9C Report for bank holding companies supervised by the Board.

⁶The Agencies intend to rely on the guidance set forth in SFAS 115 for purposes of determining whether equity securities have fair values that are "readily determinable." Under SFAS 115, the fair value of an equity security is readily determinable if sales prices or bid-and-ask quotations are currently available on a securities exchange registered with the Securities and Exchange Commission or in the over-the-counter market, provided that those prices or quotations for the over-the-counter market are publicly reported by the National Association of Securities Dealers Automated Quotations system or by the National Quotations Bureau. Restricted stock does not meet this definition. The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to above. The fair value of an investment in a mutual fund is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.

include up to 45 percent of the pretax net unrealized holding gains on available-for-sale equity securities in Tier 2 capital. The effect of the proposed rule would be to increase immediately the amount of Tier 2 capital held by institutions, including small institutions, in proportion to the amount of their qualifying pretax net unrealized holding gains on such securities. Thereafter, the amount of Tier 2 capital will increase or decrease as the value of the equity securities changes. The Agencies have concluded that this proposal will not have a significant impact on the amount of total capital held by institutions, regardless of size.

Paperwork Reduction Act

The Agencies have determined that the proposed rule does not involve a collection of information pursuant to the provisions of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*).

OCC and OTS Executive Order 12866 Determination

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

OCC and OTS Unfunded Mandates Reform Act of 1995 Determinations

Section 202 of the Unfunded Mandates Reform Act of 1995, Pub. L. 104-4 (Unfunded Mandates Act) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of \$100 million or more in any one year. If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. As discussed in the preamble, this proposed rule would permit institutions to include up to 45 percent of holding gains on available-for-sale equity securities in Tier 2 capital under the Agencies' risk-based capital rules. The proposed rule would reduce regulatory burden by increasing the amount of supplementary capital held by certain institutions. The OCC and OTS have therefore determined that the effect of the proposed rule on the thrift and banking institutions as a whole will not result in expenditures by State, local, or tribal governments or by the private sector of \$100 million or more. Accordingly, the OCC and OTS have not

prepared a budgetary impact statement or specifically addressed the regulatory alternatives considered.

List of Subjects

12 CFR Part 3

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

12 CFR Part 208

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

12 CFR Part 225

Administrative practice and procedure, Banks, banking, Federal Reserve System, Holding Companies, Reporting and recordkeeping requirements, Securities.

12 CFR Part 325

Bank deposit insurance, Banks, banking, Capital adequacy, Reporting and recordkeeping requirements, Savings associations, State non-member banks.

12 CFR Part 567

Capital, Reporting and recordkeeping requirements, Savings associations.

Authority and Issuance

Office of the Comptroller of the Currency

12 CFR CHAPTER I

For the reasons set out in the joint preamble, appendix A to part 3 of chapter I of title 12 of the Code of Federal Regulations is proposed to be amended as follows:

PART 3—MINIMUM CAPITAL RATIOS; ISSUANCE OF DIRECTIVES

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

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

2. In appendix A to part 3, section 2. is amended by adding a new paragraph (b)(5) including footnote 5 to read as follows:

Appendix A to Part 3—Risk-Based Capital Guidelines

* * * * *

Section 2. Components of Capital.

* * * * *

(b) * * *

(5) Up to 45 percent of the pretax net unrealized holding gains (the excess, if

any, of the fair value over historical cost) on available-for-sale equity securities with readily determinable fair values.⁵ Unrealized gains (losses) on other types of assets, such as bank premises or available-for-sale debt securities, are not included in supplementary capital, but the OCC may take these unrealized gains (losses) into account as additional factors when assessing overall capital adequacy.

* * * * *

Dated: October 6, 1997.

Eugene A. Ludwig, Comptroller of the Currency.

Federal Reserve System

12 CFR CHAPTER II

For the reasons set forth in the joint preamble, parts 208 and 225 of chapter II of title 12 of the Code of Federal Regulations are proposed to be amended as follows:

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

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

Authority: 12 U.S.C. 24, 36, 92(a), 93(a), 248(a), 248(c), 321-338a, 371d, 461, 481-486, 601, 611, 1814, 1816, 1818, 1820(d)(9), 1823(j), 1828(o), 1831, 1831o, 1831p-1, 1831r-1, 1835(a), 1882, 2901-2907, 3105, 3310, 3331-3351, and 3906-3909; 15 U.S.C. 78b, 78l(b), 78l(g), 78l(i), 78o-4(c)(5), 78q, 78q-1, and 78w; 31 U.S.C. 5318; 42 U.S.C. 4012a, 4104a, 4104b, 4106, and 4128.

2. In appendix A to part 208, the introductory paragraphs in section II.A.2. are revised and footnote 8 is removed and reserved to read as follows:

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

* * * * *

II. * * *

A. * * *

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.

⁵ The OCC reserves the authority to exclude all or a portion of unrealized gains from Tier 2 capital if the OCC determines that the equity securities are not prudently valued.

(iv) Term subordinated debt and intermediate-term preferred stock, including related surplus (subject to limitations discussed below).

(v) Unrealized gains on equity securities (subject to limitations discussed in paragraph II.B.2.e. of this section).

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.

* * * * *

3. In appendix A to part 208, section II.A.2., paragraphs (d) and (e) are revised to read as follows:

* * * * *

II. * * *

A. * * *

2. * * *

(d) Subordinated debt and intermediate term preferred stock. i. 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.

ii. Subordinated debt and intermediate-term preferred stock must have an original weighted average maturity of at least five years to qualify as supplemental capital. (If the holder has the option to require the issuer to redeem, repay, or repurchase the instrument prior to the 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.)¹²

iii. 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

¹² 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 limited life preferred stock eligible for inclusion in Tier 2 is reduced, or discounted, as these instruments approach maturity: one-fifth of the original amount (less redemptions) is excluded each year during the instrument's last five years before maturity. When the remaining maturity is less than one year, the instrument is excluded from Tier 2 capital.

before the stated maturity, it must receive prior approval of the Federal Reserve.

(e) *Unrealized gains on equity securities and unrealized gains (losses) on other assets.* i. Up to 45 percent of pretax net unrealized holding gains (that is, the excess, if any, of the fair value over amortized cost) on available-for-sale equity securities with readily determinable fair values may be included in supplementary capital. However, the Federal Reserve may exclude all or a portion of these unrealized gains from Tier 2 capital if the Federal Reserve determines that the equity securities are not prudently valued. Unrealized gains (losses) on other types of assets, such as bank premises and available-for-sale debt securities, are not included in supplementary capital, but the Federal Reserve may take these unrealized gains (losses) into account as additional factors when assessing a bank's overall capital adequacy.

* * * * *

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

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

Authority: 12 U.S.C. 1817(j)(13), 1818, 1828(o), 1831i, 1831p-1, 1843(c)(8), 1844(b), 1972(1), 3106, 3108, 3310, 3331-3351, 3907, and 3909.

2. In appendix A to part 225, the introductory paragraphs of section II.A.2. are revised and footnote 8 is removed and reserved to read as follows:

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

* * * * *

II. * * *
A. * * *

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).
- (v) Unrealized gains on equity securities (subject to limitations discussed in paragraph II.B.2.(e) of this section).

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.

* * * * *

3. In appendix A to part 225, section II.A.2., paragraphs (d) and (e) are revised to read as follows:

* * * * *

II. * * *
A. * * *
2. * * *

(d) *Subordinated debt and intermediate term preferred stock.* i. The aggregate amount of term subordinated debt (excluding mandatory convertible stock) 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.

ii. 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 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.)¹³

iii. 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 the right of payment to all senior indebtedness of the company.

(e) *Unrealized gains on equity securities and unrealized gains (losses) on other assets.* i. Up to 45 percent of net unrealized holding gains (that is, the excess, if any, of the fair value over amortized cost) on available-for-sale equity securities with readily determinable fair values may be

¹² Unsecured term debt issued by bank holding companies prior to March 12, 1988, and qualifying as secondary capital at the time of issuance continues 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 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 limited life preferred stock eligible for inclusion in Tier 2 is reduced, or discounted, as these instruments approach maturity: one-fifth of the original amount (less redemptions) is excluded each year during the instrument's last five years before maturity. When the remaining maturity is less than one year, the instrument is excluded from Tier 2 capital.

included in supplementary capital. However, the Federal Reserve may exclude all or a portion of these unrealized gains from Tier 2 capital if the Federal Reserve determines that the equity securities are not prudently valued. Unrealized gains (losses) on other types of assets, such as bank premises and available-for-sale debt securities, are not included in supplementary capital, but the Federal Reserve may take these unrealized gains (losses) into account as additional factors when assessing an institution's capital adequacy.

* * * * *

By order of the Board of Governors of the Federal Reserve System, October 21, 1997.

William W. Wiles,

Secretary of the Board.

**Federal Deposit Insurance Corporation
12 CFR CHAPTER III**

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

PART 325—CAPITAL MAINTENANCE

1. The authority citation for part 325 continues to read as follows:

Authority: 12 U.S.C. 1815(a), 1815(b), 1816, 1818(a), 1818(b), 1818(c), 1818(t), 1819(Tenth), 1828(c), 1828(d), 1828(i), 1828(n), 1828(o), 1831o, 1835, 3907, 3909, 4808; Pub. L. 102-233, 105 Stat. 1761, 1789, 1790 (12 U.S.C. 1831n note); Pub. L. 102-242, 105 Stat. 2236, 2355, 2386 (12 U.S.C. 1828 note).

2. In appendix A to part 325, the introductory paragraphs of section I.A.2. are revised to read as follows:

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

* * * * *

I. * * *
A. * * *

2. *Supplementary capital elements (Tier 2)* consist of:

- Allowance for loan and lease losses, up to a maximum of 1.25 percent of risk-weighted assets;
- Cumulative perpetual preferred stock, long-term preferred stock (original maturity of at least 20 years) and any related surplus;
- Perpetual preferred stock (and any related surplus) where the dividend is reset periodically based, in whole or part, on the bank's current credit standing, regardless of whether the dividends are cumulative or noncumulative;
- Hybrid capital instruments, including mandatory convertible debt securities;
- Term subordinated debt and intermediate-term preferred stock (original average maturity of five years or more) and any related surplus; and

—Net unrealized gains on equity securities (subject to limitations discussed in paragraph I.A.2.(f) of this section).

The maximum amount of Tier 2 capital that may be recognized for risk-based capital purposes is limited to 100 percent of Tier 1 capital (after any deductions for disallowed intangibles). In addition, the combined amount of term subordinated debt and intermediate-term preferred stock that may be treated as part of Tier 2 capital for risk-based capital purposes is limited to 50 percent of Tier 1 capital. Amounts in excess of these limits may be issued but are not included in the calculation of the risk-based capital ratio.

* * * * *

3. In appendix A to part 325, the last undesignated paragraph of section I.A.2., entitled "Discount of limited-life supplementary capital instruments" is designated as paragraph (e).

4. In appendix A to part 325, a new paragraph (f) is added to section I.A.2. to read as follows:

* * * * *

II. * * *

A. * * *

2. * * *

(f) *Unrealized gains on equity securities and unrealized gains (losses) on other assets.* Up to 45 percent of pretax net unrealized gains (that is, the excess, if any, of the fair value over amortized cost) on available-for-sale equity securities with readily determinable fair values may be included in supplementary capital. However, the FDIC may, on a case-by-case basis, exercise its discretion to exclude all or a portion of these unrealized gains from Tier 2 capital if the FDIC determines that the equity securities are not prudently valued. Unrealized gains (losses) on other types of assets, such as bank premises and available-for-sale debt securities, are not included in supplementary capital, but the FDIC may take these unrealized gains (losses) into account as additional factors when assessing a bank's overall capital adequacy.

* * * * *

By order of the Board of Directors.

Dated at Washington, DC, this 16th day of September 1997.

Federal Deposit Insurance Corporation.

Robert E. Feldman,
Executive Secretary.

Office of Thrift Supervision

12 CFR CHAPTER V

For the reasons set forth in the joint preamble, part 567 of chapter V of title 12 of the Code of Federal Regulations is proposed to be amended as set forth below:

PART 567—CAPITAL

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

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

2. Section 567.5 is amended by adding a new paragraph (b)(5) to read as follows:

§ 567.5 Components of capital.

* * * * *

(b) * * *

(5) *Unrealized gains on equity securities.* Up to 45 percent of net, unrealized gains before income taxes, calculated as the amount, if any, by which fair value exceeds amortized cost on available-for-sale equity securities with readily determinable fair values, may be included in supplementary capital. The OTS may disallow such inclusion in the calculation of supplementary capital if the Office determines that the equity securities are not prudently valued.

* * * * *

Dated: September 30, 1997.

By the Office of Thrift Supervision.

Nicolas P. Retsinas,

Director.

[FR Doc. 97-28269 Filed 10-24-97; 8:45 am]

BILLING CODE 4810-33-P, 6210-01-P, 6714-01-P, 6720-01-P

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Part 3

[Docket No. 97-19]

RIN 1557-AB14

FEDERAL RESERVE SYSTEM

12 CFR Part 208

[Regulation H; Docket No. R-0947]

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 325

RIN 3064-AB96

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

12 CFR Part 567

[Docket No. 97-36]

RIN 1550-AA98

Risk-Based Capital Standards: Construction Loans on Presold Residential Properties; Junior Liens on 1- to 4-Family Residential Properties; and Mutual Funds and Leverage Capital Standards: Tier 1 Leverage Ratio

AGENCIES: Office of the Comptroller of the Currency, Treasury; Board of

Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and Office of Thrift Supervision, Treasury.

ACTION: Joint notice of proposed rulemaking.

SUMMARY: The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the Agencies) are proposing to amend their respective risk-based capital standards and leverage capital standards for banks and thrifts. The proposal would represent a significant step in implementing section 303 of the Riegle Community Development and Regulatory Improvement Act of 1994, with regard to the Agencies' capital adequacy standards. (Section 303 requires the Agencies to work jointly to make uniform their regulations and guidelines implementing common statutory or supervisory policies.) The effect of the proposal would be that the Agencies would have uniform risk-based capital treatments for construction loans on presold residential properties, real estate loans secured by junior liens on 1- to 4-family residential properties, and investments in mutual funds, as well as uniform and simplified minimum Tier 1 capital leverage standards.

DATES: Comments must be received on or before December 26, 1997.

ADDRESSES: Comments should be directed to:

OCC: Comments may be submitted to Docket No. 97-19, Communications Division, Third Floor, Office of the Comptroller of the Currency, 250 E Street, S.W., Washington, D.C., 20219. Comments will be available for inspection and photocopying at that address. In addition, comments may be sent by facsimile transmission to FAX number (202) 874-5274, or by electronic mail to REGS.COMMENTS@OCC.TREAS.GOV.

Board: Comments directed to the Board should refer to Docket No. R-0947 and may be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington D.C., 20551. Comments may also be delivered to Room B-2222 of the Eccles Building between 8:45 a.m. and 5:15 p.m. weekdays, or the guard station in the Eccles Building courtyard on 20th Street, N.W. (between Constitution Avenue and C Street) at any time. Comments may be inspected in Room MP-500 of the Martin Building

between 9 a.m. and 5 p.m. weekdays, except as provided in 12 CFR 261.8 of the Federal Reserve's Rules Regarding Availability of Information.

FDIC: Written comments should be sent to Robert E. Feldman, Executive Secretary, Attention: Comments/OES, Federal Deposit Insurance Corporation, 550 17th Street N.W., Washington, D.C. 20429. Comments may be hand delivered to the guard station at the rear of the 17th Street building (located on F Street) on business days between 7:00 a.m. and 5:00 p.m. (FAX number (202) 898-3838; Internet address: comments@fdic.gov). Comments may be inspected and photocopied in the FDIC Public Information Center, Room 100, 801 17th Street, N.W., Washington, D.C. 20429, between 9:00 a.m. and 4:30 p.m. on business days.

OTS: Send comments to Manager, Dissemination Branch, Records Management and Information Policy, Office of Thrift Supervision, 1700 G Street, N.W., Washington, D.C. 20552, Attention Docket No. 97-36. These submissions may be hand-delivered to 1700 G Street, N.W., from 9:00 a.m. to 5:00 p.m. on business days; they may be sent by facsimile transmission to FAX number (202) 906-7755; or they may be sent by e-mail: public.info@ots.treas.gov. Those commenting by e-mail should include their name and telephone number. Comments will be available for inspection at 1700 G Street, N.W., from 9:00 a.m. until 4:00 p.m. on business days.

FOR FURTHER INFORMATION CONTACT:

OCC: Roger Tufts, Senior Economic Advisor (202/874-5070), Tom Rollo, National Bank Examiner (202/874-5070), Capital Policy Division; or Ronald Shimabukuro, Senior Attorney (202/874-5090), Legislative and Regulatory Activities Division.

Board: Roger Cole, Associate Director (202/452-2618), Norah Barger, Assistant Director (202/452-2402), Barbara Bouchard, Senior Supervisory Financial Analyst (202/452-3072), Division of Banking Supervision and Regulation. For the hearing impaired *only*, Telecommunication Device for the Deaf (TDD), Diane Jenkins (202/452-3544).

FDIC: For supervisory issues, Stephen G. Pfeifer, Examination Specialist, Accounting Section, Division of Supervision (202/898-8904); for legal issues, Jamey Basham, Counsel, Legal Division (202/898-7265).

OTS: John F. Connolly, Senior Program Manager for Capital Policy, (202/906-6465), Michael D. Solomon, Senior Policy Advisor (202/906-5654), Supervision Policy; or Karen Osterloh,

Assistant Chief Counsel, (202/906-6639), Regulations and Legislation Division, Office of the Chief Counsel.

SUPPLEMENTARY INFORMATION: Section 303(a)(2) of the Riegle Community Development and Regulatory Improvement Act of 1994 (12 U.S.C. 4803(a)) (Riegle Act) provides that the Agencies shall, consistent with the principles of safety and soundness, statutory law and policy, and the public interest, work jointly to make uniform all regulations and guidelines implementing common statutory or supervisory policies. Section 303(a)(1) of the Riegle Act requires the Agencies to review their own regulations and written policies and to streamline those regulations and policies where possible. To fulfill the section 303 mandate, the Agencies have been reviewing, on an interagency basis and internally, their capital standards to identify areas where they have substantively different capital treatments or where streamlining is appropriate. As a result of these reviews, the Agencies have identified inconsistencies in the risk-based capital treatment of certain types of transactions, in particular, construction loans on presold residential properties, loans secured by junior liens on 1-to 4-family residential properties, and investments in mutual funds.¹ The Agencies also believe that the minimum leverage capital standards could be streamlined and made uniform among the Agencies.

The Agencies are proposing various amendments to their risk-based capital and leverage standards to eliminate these differences and to streamline their rules.

Proposed Amendments

Construction Loans on Presold Residential Property

The Agencies all assign a qualifying loan to a builder to finance the construction of a presold 1-to 4-family residential property to the 50 percent risk weight category, provided the borrower has a substantial equity interest in the project, the property has been presold under a binding contract, the purchaser has a firm commitment for a permanent qualifying mortgage loan, and the purchaser has made a substantial earnest money deposit. Under the OCC and OTS rules, the construction loan may not receive a 50 percent risk weight unless, prior to the extension of credit to the builder, the

property was sold to an individual who will occupy the residence upon completion of construction. Under the capital rules of the Board and the FDIC, however, such loans to builders for residential construction are eligible for a 50 percent risk weight once the property is sold, even if the sale occurs after the construction loan has been made.

The Agencies are proposing to eliminate this difference by permitting qualifying residential construction loans to become eligible for the 50 percent risk weight category at the time the property is sold, even if that sale occurs after the institution has made the loan to the builder. In this regard, the OCC and OTS are proposing revised regulatory language that would permit this treatment because construction loans for residences sold to individual purchasers are equally safe regardless of whether sold before or after the loan is made to the builder. The Board is proposing a revision to its regulatory language to conform its discussion of qualifying construction loans to builders to the language of the FDIC.

Junior Liens on 1- to 4-Family Residential Properties

The Agencies are not uniform in their risk-based capital treatment of real estate loans secured by junior liens on 1-to 4-family residential properties when the lending institution also holds the first lien and no other party holds an intervening lien. In such cases, the Board views both loans as a single extension of credit secured by a first lien held by the lending institution and, accordingly, assigns the combined loan amount to either the 50 percent or 100 percent risk weight category depending upon whether certain other criteria are met.

One criterion to qualify for a 50 percent risk weight is that the loan must be made in accordance with prudent underwriting standards, including an appropriate ratio of the current loan balance to the value of the property (the loan-to-value or LTV ratio).² When considering whether a loan is consistent with prudent underwriting standards, the Board evaluates the LTV ratio based on the combined loan amount. If the combined loan amount satisfies prudent underwriting standards, both the first and second lien are assigned to the 50 percent risk weight category. The FDIC

² Other criteria include that the loan may not be 90 days or more past due or carried in nonaccrual status. The OTS rule also specifies that the documented LTV ratio may not exceed 80 percent of the securing real estate, unless the loan amount over the 80 percent LTV threshold is insured by qualifying private mortgage insurance.

¹ The Agencies also identified inconsistencies in their treatment of transactions supported by qualifying collateral, which are addressed in a pending joint notice of proposed rulemaking, 61 FR 42565 (August 16, 1996).

also combines the first and second liens to determine the appropriateness of the LTV ratio, but it applies the risk weights differently than the Board. If the combined loan amount satisfies prudent underwriting standards, the FDIC risk weights the first lien at 50 percent and the second lien at 100 percent; otherwise, both liens are risk weighted at 100 percent. The OCC treats all first and junior liens separately, even if the lending institution holds both liens and no party holds an intervening lien. Qualifying first liens are risk weighted at 50 percent, and non-qualifying first liens and all junior liens are risk weighted at 100 percent. The OTS definition of qualifying mortgage in its capital rule parallels that of the OCC, but in response to specific inquiries, the OTS has interpreted this provision to treat first and second mortgage loans to a single individual with no intervening liens as a single extension of credit.

The Agencies have decided to propose adopting the OCC's capital treatment of junior liens as the uniform interagency approach because it is simple to implement and monitor, and it treats all junior liens consistently. Under this approach, all junior liens would be assigned to the 100 percent risk weight category. The Board and the FDIC are proposing conforming revisions to their risk-based capital standards. The OTS would revisit its policy interpretation of its current rule, which parallels the OCC's text.

Mutual Funds

The Board and FDIC generally assign all of an institution's investment in a mutual fund to the risk weight category appropriate to the highest risk weighted asset that a particular mutual fund is permitted to invest in pursuant to its prospectus. As a general rule, the OCC applies the same treatment, but permits, on a case-by-case basis, an institution's investment to be allocated on a pro-rata basis among risk weight categories based on the percentages of a portfolio authorized to be invested in assets in a particular risk weight category as set forth in the fund's prospectus. The OTS generally assigns all of an institution's investment in a mutual fund to the risk weight category applicable to the highest risk weighted asset that the fund actually holds at a particular time. The OTS, however, on a case-by-case basis, permits pro-rata allocation among risk weight categories based on the fund's actual holdings. All of the Agencies' rules provide that the minimum risk weight for investments in mutual funds is 20 percent.

The Agencies are proposing to achieve uniformity in the capital

treatment of an institution's investments in mutual funds by generally assigning the institution's total investment to the risk category appropriate to the highest risk weighted asset the fund is permitted to hold in accordance with its stated investment limits set forth in the prospectus. The Agencies, however, are proposing to allow an institution, at its option, to assign the investment on a pro-rata basis to different risk weight categories according to the investment limits in the fund's prospectus, but in no case will indirect holdings through shares in a mutual fund be assigned to a risk weight less than 20 percent. For example, an institution's investment in a mutual fund that is authorized, in accordance with its prospectus, to invest up to 40 percent of its portfolio in corporate bonds and the remainder in U.S. government bonds, normally would be placed in the 100 percent risk-weight category. However, the institution could choose to place only 40 percent of its investment in the 100 percent risk weight category and the remainder in the 20 percent risk weight category. The proposed rules note that if a mutual fund is permitted to contain an insignificant quantity of highly liquid securities of superior quality that do not qualify for a preferential risk weight, such securities generally will be disregarded in determining the risk weight for the overall fund. The Agencies also emphasize that any activities which are speculative in nature or otherwise inconsistent with the preferential risk weighting assigned to the fund's assets could result in the mutual fund investment being assigned to the 100 percent risk category.

Tier 1 Leverage Ratio

The Agencies' Tier 1 leverage ratio (that is, the ratio of Tier 1 capital to total assets) is an indicator of an institution's capital adequacy and places a constraint on the degree to which an institution can leverage its equity capital base. The Board, FDIC, and OCC require the most highly-rated institutions—that is, those with, among other things, a composite 1 rating under the Uniform Financial Institutions Rating System (UFIRS)³—to meet a minimum leverage ratio of 3.0 percent. The minimum leverage ratio for other institutions is 3.0 percent “plus an additional cushion of at least 100 to 200 basis points.”

All four Agencies' prompt corrective action (PCA) rules require institutions to satisfy a 4.0 percent leverage ratio (3.0

percent for institutions with a composite 1 rating under the UFIRS) to be considered “adequately capitalized.” The OTS capital rule includes a 3.0 percent core (Tier 1) capital requirement,⁴ but the 4.0 percent standard to be adequately capitalized under the Agencies' PCA rules has been the controlling thrift leverage standard.

The Agencies are proposing revisions to their leverage capital standards so that the most highly-rated institutions would be subject to a minimum 3.0 percent leverage ratio and all other institutions would be subject to a minimum 4.0 percent leverage ratio (the same standard used to be adequately capitalized under their PCA rules). This proposed change would simplify and streamline the Agencies' leverage rules.

In addition, it would make the OTS Tier 1 leverage standard consistent with the current standard to be “adequately capitalized” under all four agencies' PCA rules and with the other agencies' Tier 1 leverage standards. The OTS is also proposing to be consistent with the other three agencies by explicitly clarifying that the prescribed leverage standard is a minimum standard for financially strong institutions, that higher capital may be required if warranted, and that institutions should maintain capital levels consistent with their risk exposure.

The Agencies request comment on all aspects of this proposal. Comment is specifically requested on the proposed treatment of first and second mortgages, which places qualifying first mortgages on 1- to 4-family residential properties in the 50 percent risk-weight category and all second mortgages in the 100 percent risk-weight category. Please comment on whether the combined loan-to-value ratio of a first and second mortgage to the same borrower, or some other criteria, provides a sound basis for modifying the proposed capital treatment of such first and second mortgages. Comment is also specifically requested on the 20 percent minimum risk weight applied to banks' investments in mutual funds. In particular, commenters are encouraged to discuss whether 20 percent is too low or too high as a lower bound in light of mutual funds' various credit, operational, and legal risks, and where these risks lie.

³The UFIRS is used by supervisors to summarize their evaluations of the strength and soundness of financial institutions in a comprehensive and uniform manner.

⁴The OTS's core capital ratio is the OTS equivalent to the other agencies' Tier 1 leverage ratio. OTS is proposing to add definitions of Tier 1 capital and Tier 2 capital to clarify that these are equivalent to core and supplementary capital, respectively.

Regulatory Flexibility Act Analysis*OCC Regulatory Flexibility Act Analysis*

Pursuant to section 605(b) of the Regulatory Flexibility Act, the OCC certifies that this proposed rule would not have a significant economic impact on a substantial number of small entities in accord with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). Accordingly, a regulatory flexibility analysis is not required. The proposed rule would reduce regulatory burden by unifying the Agencies' risk-based capital treatment for presold construction loans, junior liens, and investments in mutual funds, and simplifying the Tier 1 leverage standards. The economic impact of this proposed rule on banks, regardless of size, is expected to be minimal.

Federal Reserve Board Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act, the Board does not believe this proposal would have a significant impact on a substantial number of small business entities in accord with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). Accordingly, a regulatory flexibility analysis is not required. The effect of the proposal would be to reduce regulatory burden on depository institutions by unifying the Agencies' risk-based capital treatment for presold construction loans, junior liens, and investments in mutual funds, and simplifying the Tier 1 leverage standards. The economic impact of the proposed rule on institutions, regardless of size, is expected to be minimal.

FDIC Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act (Pub. L. 96-354, 5 U.S.C. 601 *et seq.*), it is certified that the proposal would not have a significant impact on a substantial number of small entities. The effect of the proposal would be to simplify depository institutions' capital calculations.

OTS Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act, the OTS certifies that this proposed rule will not have a significant economic impact on a substantial number of small entities. The effect of the proposal would be to reduce regulatory burden on depository institutions by simplifying the treatment of junior liens, permitting institutions to risk weight holdings in a mutual fund on a pro rata basis, and making OTS'

Tier 1 leverage ratio consistent with its current standard to be adequately capitalized under PCA. In addition, the proposal will eliminate various inconsistencies in the risk-based capital treatments applied by the Agencies.

Paperwork Reduction Act

The Agencies have determined that the proposed rule does not involve a collection of information pursuant to the provisions of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*).

OCC and OTS Executive Order 12866 Determination

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

OCC and OTS Unfunded Mandates Reform Act of 1995 Determinations

Section 202 of the Unfunded Mandates Reform Act of 1995, Pub. L. 104-4 (Unfunded Mandates Act) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of \$100 million or more in any one year. If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. As discussed in the preamble, this proposed rule is limited to changing the risk weighting of presold residential construction loans, second liens, and mutual fund investments under the Agencies' risk-based capital rules. It also establishes a uniform, simplified leverage requirement for all institutions. In addition, with respect to the OCC, this proposal clarifies and makes uniform existing regulatory requirements for national banks. The OCC and OTS have therefore determined that the proposed rule will not result in expenditures by State, local, or tribal governments or by the private sector of \$100 million or more. Accordingly, the OCC and OTS have not prepared a budgetary impact statement or specifically addressed the regulatory alternatives considered.

List of Subjects*12 CFR Part 3*

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

12 CFR Part 208

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

12 CFR Part 325

Bank deposit insurance, Banks, banking, Capital adequacy, Reporting and recordkeeping requirements, Savings associations, State non-member banks.

12 CFR Part 567

Capital, Reporting and recordkeeping requirements, Savings associations.

Authority and Issuance**Office of the Comptroller of the Currency****12 CFR CHAPTER I**

For the reasons set out in the joint preamble, part 3 of chapter I of title 12 of the Code of Federal Regulations is proposed to be amended as follows:

PART 3—MINIMUM CAPITAL RATIOS; ISSUANCE OF DIRECTIVES

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

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

2. In § 3.6, paragraph (c) is revised to read as follows:

§ 3.6 Minimum capital ratios.

* * * * *

(c) *Additional leverage ratio requirement.* An institution operating at or near the level in paragraph (b) of this section is expected to have well-diversified risks, including no undue interest rate risk exposure; excellent control systems; good earnings, high asset quality; high liquidity; and well managed on- and off-balance sheet activities; and in general be considered a strong banking organization, rated composite 1 under the Uniform Financial Institutions Rating System (CAMELS) rating system of banks. For all but the most highly-rated banks meeting the conditions set forth in this paragraph, the minimum Tier 1 leverage ratio is to be 4 percent. In all cases, banking institutions should hold capital commensurate with the level and nature of all risks.

3. In appendix A to part 3, section 3., the second undesignated paragraph and paragraph (a)(3)(iv) are revised to read as follows:

APPENDIX A TO PART 3—RISK BASED CAPITAL GUIDELINES

* * * * *

Section 3. Risk Categories/Weights for On-Balance Sheet Assets and Off-Balance Sheet Items

* * * * *

Some of the assets on a bank's balance sheet may represent an indirect holding of a pool of assets, e.g., mutual funds, that encompass more than one risk weight within the pool. In those situations, the bank may assign the asset to the risk category applicable to the highest risk-weighted asset that pool is permitted to hold pursuant to its stated investment objectives in the fund's prospectus. Alternatively, the bank may assign the asset on a pro rata basis to different risk categories according to the investment limits in the fund's prospectus. In either case, the minimum risk weight that the bank may assign to such a pool is 20 percent. If, in order to maintain a necessary degree of liquidity, the fund is permitted to hold an insignificant amount of its investments in short-term, highly-liquid securities of superior credit quality (that do not qualify for a preferential risk weight), such securities generally will not be taken into account in determining the risk category into which the bank's holding in the overall pool should be assigned. The prudent use of hedging instruments by a mutual fund to reduce the risk of its assets will not increase the risk weighting of that fund above the 20 percent category. More detail on the treatment of mortgage-backed securities is provided in section 3(a)(3)(vi) of this appendix A.

- (a) * * *
(3) * * *
(iv) Loans to residential real estate builders for one-to-four family residential property construction, if the bank obtains sufficient documentation demonstrating that the buyer of the home intends to purchase the home (i.e., a legally binding written sales contract) and has the ability to obtain a mortgage loan sufficient to purchase the home (i.e., a firm written commitment for permanent financing of the home upon completion), subject to the following additional criteria:

* * * * *

Dated: September 29, 1997.

Eugene A. Ludwig, Comptroller of the Currency.

Federal Reserve System

12 CFR CHAPTER II

For the reasons set forth in the joint preamble, part 208 of chapter II of title 12 of the Code of Federal Regulations is proposed to be amended as follows:

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

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

Authority: 12 U.S.C. 24, 36, 92(a), 93(a), 248(a), 248(c), 321-338a, 371d, 461, 481-486,

601, 611, 1814, 1816, 1818, 1820(d)(9), 1823(j), 1828(o), 1831, 1831o, 1831p-1, r-1, 1835(a), 1882, 2901-2907, 3105, 3310, 3331-3351, and 3906-3909; 15 U.S.C. 78b, 78l(b), 78l(g), 78l(i), 78o-4(c)(5), 78q, 78q-1, and 78w; 31 U.S.C. 5318; 42 U.S.C. 4012a, 4104a, 4104b, 4106, and 4128.

2. In appendix A to part 208, section III. A., footnote 21 is revised to read as follows:

APPENDIX A TO PART 208—CAPITAL ADEQUACY GUIDELINES FOR STATE MEMBER BANKS: RISK-BASED MEASURE

* * * * *

III. * * *
A. * * * 21

* * * * *

3. In appendix A to part 208, section III.C.3. is amended by removing and reserving footnote 34 and by adding a new sentence to the end of the first paragraph of footnote 35 to read as follows:

* * * * *

III. * * *
C. * * *
3. * * * 35

* * * * *

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

21 An investment in shares of a mutual fund whose portfolio consists solely of various securities or money market instruments that, if held separately, would be assigned to different risk categories, generally is assigned to the risk category appropriate to the highest risk-weighted asset that the fund is permitted to hold in accordance with the stated investment objectives set forth in the prospectus. The bank may, at its option, assign the investment on a pro rata basis to different risk categories according to the investment limits in the fund's prospectus, but in no case will indirect holdings through shares in any mutual fund be assigned to a risk weight less than 20 percent. 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 generally will be disregarded in determining the risk category into which the bank's holding in the overall fund should be assigned. The prudent use of hedging instruments by a mutual fund to reduce the risk of its assets will not increase the risk weighting of the mutual fund investment. For example, the use of hedging instruments by a mutual fund to reduce the interest rate risk of its government bond portfolio will not increase the risk weight of that fund above the 20 percent category. Nonetheless, if the fund engages in any activities that appear speculative in nature or has any other characteristics that are inconsistent with the preferential risk weighting assigned to the fund's assets, holdings in the fund will be assigned to the 100 percent risk category.

35 * * * Such loans to builders will be considered prudently underwritten only if the bank has obtained sufficient documentation that the buyer of the home intends to purchase the home (i.e., has a legally binding written sales contract) and has the ability to obtain a mortgage loan sufficient to purchase the home (i.e., has a firm written commitment for permanent financing of the home upon completion).

APPENDIX B TO PART 208—CAPITAL ADEQUACY GUIDELINES FOR STATE MEMBER BANKS: TIER 1 LEVERAGE MEASURE

* * * * *

II. * * *
a. For a strong banking organization (rated composite 1 under the UFIRS rating system of banks) the minimum ratio of Tier 1 capital to total assets is 3.0 percent. Such institutions must not be anticipating or experiencing significant growth, and are expected to have well-diversified risk (including no undue interest rate risk exposure), excellent asset quality, high liquidity, good earnings, and in general to be considered a strong banking organization. For all other institutions, the minimum ratio is 4.0 percent. Higher capital ratios could be required if warranted by the particular circumstances or risk profiles of individual banks. 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.

* * * * *

By order of the Board of Governors of the Federal Reserve System, October 21, 1997.

William W. Wiles, Secretary of the Board.

Federal Deposit Insurance Corporation 12 CFR CHAPTER III

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

PART 325—CAPITAL MAINTENANCE

1. The authority citation for part 325 continues to read as follows:

Authority: 12 U.S.C. 1815(a), 1815(b), 1816, 1818(a), 1818(b), 1818(c), 1818(t), 1819(Tenth), 1828(c), 1828(d), 1828(i), 1828(n), 1828(o), 1831o, 1835, 3907, 3909, 4808; Pub. L. 102-233, 105 Stat. 1761, 1789, 1790 (12 U.S.C. 1831n note); Pub. L. 102-242, 105 Stat. 2236, 2355, 2386 (12 U.S.C. 1828 note).

2. Paragraph (b)(2) in § 325.3 is revised to read as follows:

§ 325.3 Minimum leverage capital requirement.

* * * * *

(b) * * *
(2) For all but the most highly-rated institutions meeting the conditions set forth in paragraph (b)(1) of this section, the minimum leverage capital requirement for a bank (or for an insured depository institution making an application to the FDIC) shall consist of a ratio of Tier 1 capital to total assets of not less than 4 percent.

* * * * *

3. In appendix A to part 325, section II.B., paragraph 1 is revised to read as follows:

**APPENDIX A TO PART 325—
STATEMENT OF POLICY ON RISK-
BASED CAPITAL**

* * * * *

II. * * *
B. * * *

1. *Indirect Holdings of Assets.* Some of the assets on a bank's balance sheet may represent an indirect holding of a pool of assets; for example, mutual funds. An investment in shares of a mutual fund whose portfolio consists solely of various securities or money market instruments that, if held separately, would be assigned to different risk categories, generally is assigned to the risk category appropriate to the highest risk-weighted asset that the fund is permitted to hold in accordance with the stated investment objectives set forth in its prospectus. The bank may, at its option, assign the investment on a pro rata basis to different risk categories according to the investment limits in the fund's prospectus, but in no case will indirect holdings through shares in any mutual fund be assigned to a risk weight less than 20 percent. 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 generally will be disregarded in determining the risk category into which the bank's holding in the overall fund should be assigned. The prudent use of hedging instruments by a mutual fund to reduce the risk of its assets will not increase the risk weighting of the mutual fund investment. For example, the use of hedging instruments by a mutual fund to reduce the interest rate risk of its government bond portfolio will not increase the risk weight of that fund above the 20 percent category. Nonetheless, if the fund engages in any activities that appear speculative in nature or has any other characteristics that are inconsistent with the preferential risk weighting assigned to the fund's assets, holdings in the fund will be assigned to the 100 percent risk category.

* * * * *

4. In appendix A to part 325, section II.C. is amended by removing and reserving footnote 26.

By order of the Board of Directors.

Dated at Washington, D.C. this 4th day of February 1997.

Federal Deposit Insurance Corporation.

Jerry L. Langley,
Executive Secretary.

Office of Thrift Supervision

12 CFR CHAPTER V

For the reasons set forth in the joint preamble, part 567 of chapter V of title 12 of the Code of Federal Regulations is proposed to be amended as set forth below:

PART 567—CAPITAL

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

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

2. In § 567.1, paragraph (jj)(1)(ii) is revised, and new paragraphs (mm) and (nn) are added to read as follows:

§ 567.1 Definitions.

* * * * *

(jj) *Qualifying residential construction loan.* (1) * * *

(ii) The residence being constructed must be a 1-4 family residence sold to a home purchaser;

* * * * *

(mm) *Tier 1 capital.* The term *Tier 1 capital* means core capital as computed in accordance with § 567.5(a) of this part.

(nn) *Tier 2 capital.* The term *Tier 2 capital* means supplementary capital as computed in accordance with § 567.5(b) of this part.

3. Section 567.2(a)(2)(ii) is revised to read as follows:

§ 567.2 Minimum regulatory capital requirement.

(a) * * *

(2) *Leverage ratio requirement.* * * *

(ii) A savings association must satisfy this requirement with core capital as defined in § 567.5(a) of this part.

* * * * *

4. Section 567.6(a)(1)(vi) is revised to read as follows:

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

(a) * * *

(1) * * *

(vi) *Indirect ownership interests in pools of assets.* An asset representing an indirect holding of a pool of assets, e.g., mutual funds, generally is assigned to the risk-weight category under this section based upon the risk weight that would be assigned to the assets in the portfolio of the pool. An investment in shares of a mutual fund whose portfolio consists solely of various securities or money market instruments that, if held separately, would be assigned to different risk-weight categories,

generally is assigned to the risk-weight category appropriate to the highest risk-weighted asset that the fund is permitted to hold in accordance with the investment objectives set forth in its prospectus. The savings association may, at its option, assign the investment on a pro-rata basis to different risk-weight categories according to the investment limits in the fund's prospectus. In no case will an indirect holding through shares in a mutual fund be assigned to the zero percent risk-weight 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 generally will be disregarded in determining the risk-weight category into which the savings association's holding in the overall fund should be assigned. The prudent use of hedging instruments by a mutual fund to reduce the risk of its assets will not increase the risk weighting of the mutual fund investment. For example, the use of hedging instruments by a mutual fund to reduce the interest rate risk of its government bond portfolio will not increase the risk weight of that fund above the 20 percent category. Nonetheless, if the fund engages in any activities that appear speculative in nature or has any other characteristics that are inconsistent with the preferential risk-weighting assigned to the fund's assets, holdings in the fund will be assigned to the 100 percent risk-weight category.

* * * * *

5. Section 567.8 is revised to read as follows:

§ 567.8 Leverage ratio.

(a) The minimum leverage capital requirement for a savings association assigned a composite rating of 1, as defined in § 516.3(c) of this chapter, shall consist of a ratio of core capital to adjusted total assets of 3 percent. These generally are strong associations that are not anticipating or experiencing significant growth and have well-diversified risks, including no undue interest rate risk exposure, excellent asset quality, high liquidity, and good earnings.

(b) For all savings associations not meeting the conditions set forth in paragraph (a) of this section, the minimum leverage capital requirement shall consist of a ratio of core capital to adjusted total assets of 4 percent. Higher capital ratios may be required if warranted by the particular circumstances or risk profiles of an

individual savings association. In all cases, savings associations should hold capital commensurate with the level and nature of all risks, including the volume and severity of problems loans, to which they are exposed.

Dated: April 17, 1997.

The Office of Thrift Supervision.

Nicolas P. Retsinas,
Director.

[FR Doc. 97-28270 Filed 10-24-97; 8:45 am]

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6720-01-P

FEDERAL RESERVE SYSTEM

12 CFR Part 225

[Regulation Y; Docket No. R-0948]

Risk-Based Capital Standards: Construction Loans on Presold Residential Properties; Junior Liens on 1- to 4-Family Residential Properties; and Mutual Funds and Leverage Capital Standards: Tier 1 Leverage Ratio

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice of proposed rulemaking.

SUMMARY: The Board of Governors of the Federal Reserve System is proposing to amend its risk-based capital guidelines for bank holding companies by revising the treatment for junior liens on 1- to 4-family residential properties and mutual funds and the language for construction loans on presold residential properties, and to simplify the leverage capital guidelines for bank holding companies. The proposal, which was developed on an interagency basis, would implement part of section 303 of the Riegle Community Development and Regulatory Improvement Act of 1994, which requires the Federal banking agencies to work jointly to make uniform their regulations and guidelines implementing common statutory or supervisory policies. The effect of the proposal would be that the bank holding company risk-based capital treatment for construction loans on presold residential properties, real estate loans secured by junior liens on 1- to 4-family residential properties, and investments in mutual funds would be consistent with the risk-based capital treatment of the other Federal banking and thrift regulatory agencies, and the bank holding company Tier 1 leverage standards would be simplified and revised to take into account the market risk capital rule.

DATES: Comments must be received on or before December 26, 1997.

ADDRESSES: Comments should refer to Docket No. R-0948 and may be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington D.C., 20551. Comments may also be delivered to Room B-2222 of the Eccles Building between 8:45 a.m. and 5:15 p.m. weekdays, or the guard station in the Eccles Building courtyard on 20th Street, N.W. (between Constitution Avenue and C Street) at any time. Comments may be inspected in Room MP-500 of the Martin Building between 9 a.m. and 5 p.m. weekdays, except as provided in 12 CFR 261.8 of the Board's Rules Regarding Availability of Information.

FOR FURTHER INFORMATION CONTACT: Roger Cole, Associate Director (202/452-2618); Norah Barger, Assistant Director (202/452-2402); or Barbara Bouchard, Senior Supervisory Financial Analyst (202/452-3072), Division of Banking Supervision and Regulation. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Diane Jenkins (202/452-3544).

SUPPLEMENTARY INFORMATION: The Federal Reserve, along with the other bank and thrift regulatory agencies (that is, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the Agencies)), issued a joint notice of proposed rulemaking, published elsewhere in today's **Federal Register**, under Docket No. R-0947. In that joint notice, the Agencies have proposed several amendments to their risk-based capital standards that would eliminate inconsistencies among the capital rules for banks and thrifts. In particular, the Agencies have proposed amendments to the risk-based capital treatment of construction loans on presold residential properties, loans secured by junior liens on 1- to 4-family residential property, and investments in mutual funds. The agencies also have proposed a streamlining revision to their leverage capital rules. The Federal Reserve, in this notice, is proposing conforming amendments to its risk-based capital guidelines for bank holding companies, as well as a streamlining revision to its leverage capital guidelines for such organizations, that takes into account the market risk capital rule (12 CFR part 225, appendix E).

Proposed Amendments to the Risk-Based Capital Guidelines

With regard to construction loans on presold residential properties, the Board

is not proposing any substantive change to its rule, but is proposing a revision to the regulatory language to provide guidance on the characteristics of loans to builders that will be considered prudently underwritten. This change would conform the discussion of qualifying construction loans to builders to the existing language of the FDIC. For junior liens on 1- to 4-family properties, the Board is proposing to treat all first and second liens separately, even if the lending institution holds both liens and no party holds an intervening lien. Under the proposed treatment, qualifying first liens would be risk weighted at 50 percent, and non-qualifying first liens and all junior liens would be risk weighted at 100 percent. The Federal Reserve is proposing to retain its general treatment for investments in mutual funds, that is, generally assigning an institution's investment in a mutual fund to the highest risk-weight category applicable to any asset the fund is authorized to hold in accordance with its prospectus. The Federal Reserve is also proposing to allow an institution, at its option, to allocate its investment in a mutual fund among the risk-weight categories based on the maximum percentage of the mutual fund's portfolio that may consist of higher risk-weighted assets under its prospectus. These proposed revisions are consistent with the Federal Reserve's proposed amendments for state member banks that are set forth in the earlier referenced interagency notice of proposed rulemaking.

Proposed Amendment to the Tier 1 Leverage Guidelines

The Federal Reserve's capital adequacy guidelines for bank holding companies set forth the following minimum levels of Tier 1 capital to total assets (leverage ratio): a 3 percent minimum for organizations rated a composite 1 under the BOPEC¹ rating system for bank holding companies and a minimum of 3 percent plus 100 to 200 basis points for all other organizations. The Federal Reserve is proposing to amend its guidelines to set forth a minimum 3 percent leverage ratio for bank holding companies that are BOPEC 1-rated or have implemented the risk-based capital market risk measure set forth in the Board's capital adequacy guidelines (12 CFR part 225, appendix E). All other bank holding companies would be subject to a 4 percent minimum Tier 1 leverage ratio. Higher

¹ The BOPEC rating system is used by supervisors to summarize their evaluations of the strength and soundness of bank holding companies in a comprehensive and uniform manner.

capital ratios could be required if warranted by the particular circumstances or risk profiles of individual banking organizations. Institutions with supervisory, financial, or operational weaknesses would continue to be expected to operate well above minimum capital levels. Organizations experiencing or anticipating significant growth also would be expected to maintain capital ratios, including tangible capital positions, well above the minimum.

The Federal Reserve notes that this proposed amendment would lower the minimum Tier 1 leverage ratio for institutions that have implemented the market risk capital rule. While the Federal Reserve believes it is desirable for bank holding companies to maintain a minimum base of capital to total assets, it also recognizes that the leverage ratio can be an inexact measure of capital adequacy for many bank holding companies, particularly for very large organizations that have significant trading portfolios and are extensively engaged in fee-generating off-balance-sheet activity. Accordingly, in light of the revisions to the risk-based capital measure to capture market risk as well as credit risk, the Federal Reserve believes it is appropriate to lower the minimum Tier 1 leverage ratio to 3 percent for bank holding companies that have implemented the market risk rule.

The Federal Reserve requests comment on all aspects of this proposal. With regard to the proposed treatment for first and second liens, the Board notes that it continues to believe its current approach of merging first and second liens more appropriately reflects the risk of those transactions. This is because, in terms of an institution's collateral position, funds advanced on both the first and second note are effectively secured by a first lien and timely payment in accordance with the terms of both loans depends on the same borrower's financial ability to pay. Furthermore, the Board believes that merging these liens is consistent with general industry practice. Thus, the Board requests, in particular, comment on the proposed treatment for first and second liens.

Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act, the Board does not believe the proposed rule would have a significant impact on a substantial number of small business entities in accord with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). Accordingly, a regulatory flexibility analysis is not required. In addition, because the risk-

based capital guidelines generally do not apply to bank holding companies with consolidated assets of less than \$150 million, the proposed rule would not affect such companies. The effect of the proposed rule would be to reduce regulatory burden on bank holding companies by unifying the Agencies' risk-based capital treatment for presold construction loans, junior liens, and investments in mutual funds, and simplifying the Tier 1 leverage standards.

Paperwork Reduction Act

The Board has determined that the proposed rule does not involve a collection of information pursuant to the provisions of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*).

List of Subjects in 12 CFR Part 225

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

For the reasons set forth in the preamble, part 225 of chapter II of title 12 of the Code of Federal Regulations is proposed to be amended as follows:

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

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

Authority: 12 U.S.C. 1817(j)(13), 1818, 1828(o), 1831i, 1831p-1, 1843(c)(8), 1844(b), 1972(1), 3106, 3108, 3310, 3331-3351, 3907, and 3909.

2. In appendix A to part 225, section III.A., footnote 24 is revised to read as follows:

APPENDIX A TO PART 225—CAPITAL ADEQUACY GUIDELINES FOR BANK HOLDING COMPANIES: RISK-BASED MEASURE

* * * * *
 III. * * *
 A. * * * 24

²⁴ An investment in shares of a mutual fund whose portfolio consists solely of various securities or money market instruments that, if held separately, would be assigned to different risk categories, generally is assigned to the risk category appropriate to the highest risk-weighted asset that the fund is permitted to hold in accordance with the stated investment objectives as set forth in the prospectus. The organization may, at its option, assign the investment on a pro rata basis to different risk categories according to the investment limits in the fund's prospectus, but in no case will indirect holdings through shares in any mutual fund be assigned to a risk weight less than 20 percent. 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,

* * * * *

3. In appendix A to part 225, section III.C.3. is amended by removing and reserving footnote 37 and by adding a new sentence to the end of the footnote 38 to read as follows:

* * * * *
 III. * * *
 C. * * *
 3. * * * 38 * * *
 * * * * *

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

APPENDIX D TO PART 225—CAPITAL ADEQUACY GUIDELINES FOR BANK HOLDING COMPANIES: TIER 1 LEVERAGE MEASURE

* * * * *
 II. * * *

a. For a strong banking organization (rated composite 1 under the BOPEC rating system of bank holding companies or has implemented the Board's risk-based capital measure for market risk as set forth in appendices A and E of this part) the minimum ratio of Tier 1 capital to total assets is 3.0 percent. Such organizations must not be anticipating or experiencing significant growth, are expected to have well diversified risk (including no undue interest rate risk exposure), excellent asset quality, high liquidity, good earnings, and in general be considered a strong banking organization. In addition, organizations are expected to maintain capital ratios, including tangible capital positions, well above minimum levels. For all other bank holding companies, the minimum ratio is 4.0 percent. Higher capital ratios could be required if warranted by the particular circumstances or risk profiles of individual banking organizations. In all cases, bank holding companies 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.

* * * * *

highly liquid securities of superior credit quality that do not qualify for a preferential risk weight, such securities generally will be disregarded in determining the risk category into which the organization's holding in the overall fund should be assigned. The prudent use of hedging instruments by a mutual fund to reduce the risk of its assets will not increase the risk weighting of the mutual fund investment. For example, the use of hedging instruments by a mutual fund to reduce the interest rate risk of its government bond portfolio will not increase the risk weight of that fund above the 20 percent category. Nonetheless, if the fund engages in any activities that appear speculative in nature or has any other characteristics that are inconsistent with the preferential risk weighting assigned to the fund's assets, holdings in the fund will be assigned to the 100 percent risk category.

³⁸ * * * Such loans to builders will be considered prudently underwritten only if the bank holding company has obtained sufficient documentation that the buyer of the home intends to purchase the home (i.e., has a legally binding written sales contract) and has the ability to obtain a mortgage loan sufficient to purchase the home (i.e., has a firm written commitment for permanent financing of the home upon completion).

By order of the Board of Governors of the
Federal Reserve System, October 21, 1997.

William W. Wiles,

Secretary of the Board.

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